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Student Loan Reauthorization Options [1]

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April 2, 1997

MEMORANDUM FOR GENE SPERLING

FROM: **BOB SHIREMAN**

RE: **Student Loan Reforms in the Budget**

The current structure of the guarantee system encourages inefficiency, provides perverse incentives, delivers poor-quality service to the government (and often to students), and costs taxpayers more than necessary. The President's Budget addresses these problems through a number of reforms saving a total of $4.4 billion over five years (CBO). We then spend $1.3 billion to reduce the fees on the loans. **The net savings are $3.1 billion.**

The Republicans continue to require CBO to include long-term administrative costs in the scoring of direct loans. **This increases the baseline (and therefore the deficit) by $2.9 billion**.

Chairman Goodling and others (including some Democrats) argue that the student loan reforms belong in the reauthorization of the Higher Education Act, not in the reconciliation bill. I do not know where Domenici and Kasich stand on this issue, but someone may propose that if the Administration drops its insistence that student loans be included in reconciliation, then the Republicans will reverse their directed scorekeeping. **The result would be nearly a wash.**[1]

Sen. Domenici is apparently looking at "savers" without including any "costers." In that light, the student loan reforms could potentially save $5 billion. Therefore, even with the directed scorekeeping, a net of about $2 billion could be saved if the student savings and other costers are not included.

Our two largest savers are:

1. Reserve funds. The current structure is based on the fiction that the middleman agencies actually "guarantee" the loans. They do not. They simply administer the Federal guarantee. The Budget would recognize this fact, allowing for the return of $2.5 billion in Federal funds currently held by the agencies.

2. In-school interest rate. Currently, the interest rate on student loans is T-bill plus 3.1 percentage

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[1]A possible advantage with this approach is that if the budget deal is already done by the time reauthorization is considered, we could insist that a *larger* portion of the savings go to students. On the other hand, though, our negotiating hand is seriously weakened if this is not addressed in reconciliation.

points during repayment, but it is 0.6 points lower during the in-school period (when the government pays the interest -- on most loans -- and the lender has no servicing costs). In FY 98 (under current law) the interest rate becomes the 10-year bond rate plus one percentage point, with no differential during the in-school period. The Budget would lower the rate during the in-school period by one percentage point (so it would equal the 10-year bond rate), saving $1.2 billion.

This bill also proposes substantial improvements in the way financial need is determined for disadvantaged independent students who do not have dependents (other than a spouse). The bill would set the income protection allowances for independent students who do not have dependents in the same way as the allowances used for other students. The Administration has included an amendment in the 1998 appropriation language for the 1998-99 award year. This bill would make a permanent change to the HEA for later years.

The proposed bill would amend the HEA to reduce loan fees for students by $2.6 billion over five years and lower interest rates for Unsubsidized Stafford Loan borrowers by one percentage point, thereby saving students an additional $1 billion over five years. The bill also would standardize benefits for students, to the extent practicable, across the Direct Loan and Federal Family Education Loan (FFEL) programs, and address a number of structural problems and inefficiencies in the FFEL program.

Under this bill, borrowers would realize substantial benefits as loan origination fees are cut in half for the neediest students and by 25 percent for others. Interest rates on Unsubsidized Stafford loans would be lowered by one percentage point while borrowers are in school. Lenders would be required to offer the same terms to all borrowers for the same type of loan--just as the government is required to do under the Direct Loan program. Borrowers who consolidate loans within FFEL would receive the same interest rates and comparable benefits to those who consolidate in Direct Loans.

This bill proposes a number of changes to the FFEL guaranty agency system in recognition that these State and private nonprofit entities are not the ultimate guarantors of FFEL and act only as administrative agents of the Federal government. Because the Federal government is the sole insurer of FFEL loans, the Secretary would undertake the obligation to pay lenders directly using his agents and recall guaranty agency reserves over the next five years, saving some $2.5 billion.

To address structural deficiencies that hamper default prevention activities, guaranty agencies would be authorized to retain no more than 18.5 percent of default collections--comparable to the Department's cost of collections--not the arbitrary 27 percent guaranty agencies retain under current law. Guaranty agencies would receive a default prevention fee from lenders when delinquent loans are brought current. To further encourage default prevention, lender risk-sharing would be increased to 5 percent from 2 percent, and lenders would be required to offer borrowers certain additional flexible repayment options now offered under the Direct Loan program.

A more complete summary of the bill's provisions is contained in the Section-By-Section Analysis enclosed with this letter.

This bill is part of an ambitious national agenda--an agenda for the next century that places education at the center and recognizes that all workers need to possess ever higher levels of skills throughout their lifetime. Provisions in this bill reflect the Administration's strong belief that we must raise educational expectations and make 14 years of education the standard for every American. At the same time, this bill offers substantial increases in benefits to needy students, significant, targeted education tax relief to working and middle-income families, and lifelong learning opportunities for all Americans.

The HOPE Act creates a powerful new way for the Nation to invest in its citizens and the economy. I urge you to join me in supporting this legislation. The Office of Management and Budget advises that there is no objection to the submission of this legislation to the Congress and that its enactment would be ing on the Ways and Means staff to get the President's economic plan through the House, the administration caved. Who says politicians have all the power?

Petty though it was, this episode had unfortunate consequences. Whether offered by the government or banks, pay-as-you-can loans are unlikely to work unless the IRS is involved. And at this stage in the game, IRS involvement will not be an easy sell. After all, it's the agency everyone—particularly the Republicans who now control Congress—loves to hate. But a firm commitment from the President could go a long way. Instead of criss-crossing the country stumping for tax deductions, Clinton ought to be using his considerable powers of persuasion to explain the benefits of IRS loan collection. After all, the purpose of using the IRS would be to crack regardless of how much he has paid back. Although the 25-year forgiveness option had been floating around for years, the decision to incorporate it was, once again, dictated by staffers and disturbingly free of thoughtful debate. According to Waldman, a 20-year provision was thrown in at the suggestion of aides to Senators Nancy Kassebaum and James Jeffords just before the Senate mark-up—after a discussion of no more than 10 minutes. Later, in conference committee, the amnesty was changed to 25 years—again with minimal consideration.

Proponents of the forgiveness clause maintain that if it's taking someone such a long time to pay off their loan, chances are they are repaying it in installments that are so small they're not even covering the monthly interest on the money they still owe. As a result, amount that is forgiven, and these can be very high.

But the greatest danger is that by forgiving the loan, the government is, at worst, rewarding irresponsibility, and at best, over-compensating those who are happily pursuing their life's dream without having to worry about paying back the taxpayers who helped them accomplish it. Most importantly, the provision is fundamentally unfair to the folks who work hard to repay their loans before the cut-off.

Long-term loans of say, 35 years, are not without their disadvantages. As anyone with a home mortgage will attest, the longer the term of a loan, the greater the interest that must be paid on it. But just as long-term mortgages democratized home ownership in America, so can long-term student loans democratize high-

Guaranteed Rip-Off

While it's a good idea to keep commercial banks in the student loan business, the current system is badly in need of reform. Back in the 1960s, when the federal student loan program was first established, banks were wary of lending to young students with no credit history and no collateral. To entice them, the government offered to subsidize and even guarantee all student loans. Although these loans have since proved extremely profitable, almost all of the original perks are still in place. In 1996 the government paid out $3.6 billion in subsidies and guarantees to generate $16.4 billion in loans—that's about 22 percent in overhead.

The system is clearly bloated with overly generous handouts. To Clinton's credit he wants to cut many of them, for a total savings of $34.7 billion over five years. Among the worst perks are large bank subsidies and unnecessary benefits to secondary markets (like "Sallie Mae") that buy loans from them. But by far the most outrageous racket is being run by the system's middlemen: the "guaranty agencies." These quasi-governmental entities use federal funds to reimburse banks for defaulted loans and then attempt to collect the money from students. If they succeed, they get to keep a whopping 27 percent of what they recover—compared to the average 18.5 percent private collection companies pocket. If they fail, they just pass the bill on to Uncle Sam.

Clinton estimates that by lowering the 27 percent rate to 18.5 percent, taxpayers would save $457 million over five years. In addition, he predicts a five year savings of $110 million by making banks pay the allowance guaranty agencies get for attempting to prevent defaults—money they keep regardless of whether they are actually successful. Then there's the $690 million students would save if guaranty agencies were prohibited from charging them a one percent fee. That's on top of the administrative fee the agencies charge the government. Finally, there are the $2.5 billion in government reserves the agencies are sitting on. The reserves were originally intended to help agencies cover defaulted loans. But since almost all reimbursements come directly from the government, the reserves are unnecessary.

Clinton is right to try to cut all this fat out. But he faces a tough fight against a powerful foe. Although the biggest guaranty agencies are technically not-for-profit corporations, these enterprises are some of the most lucrative in America. The largest, part of a company called USA Group, earned over $100 million in tax-free revenues above its expenditures in 1995. USA Group's then-CEO Roy Nicholson got a $1 million salary that year, and its top 6 officials averaged $400,000 a piece. These executives have their offices in the company's sleek $32 million Fishers, Indiana headquarters. And they make large campaign contributions to sympathetic Republicans. *The Baltimore Sun*'s David Folkenflik reports that USA Group executives gave out more than $30,000 in personal contributions in 1994 and almost $70,000 in 1996. The firm has also paid over a million dollars to Washington "consultants"—all for the purpose of preserving the system which has served it so well.

USA Group argues that the fees it charges allow it to provide high quality service, and the salaries it pays attract executives who must also run for-profit affiliates.

But this raises the question of why guaranty agencies need to be non-profit in the first place. They should either be privatized, and forced to offer competitive prices and pay taxes on their profits, or they should be replaced by the IRS, which would simply add loan repayment to the tax it already collects—eliminating much of the 22 percent in overhead the government currently spends to generate student loans.

—N.C.A.

A Rift Forms Among Loan-Guarantee Agencies

Industry lobbyists oppose Clinton's proposals, but some state officials are open to them

BY STEPHEN BURD

WHEN President Clinton suggested overhauling the guaranteed-student-loan program in his budget proposal for fiscal 1998, lobbyists for the agencies that guarantee the loans responded quickly and harshly.

The President's plan "threatens the viability of the nation's largest college-student financial-aid program and may threaten to endanger the future stability of student lending in this country," said Brett E. Lief, president of the National Council of Higher Education Loan Programs, which represents guarantee agencies.

He and other officials in the guaranteed-loan program objected in particular because the President's plan would strip the guarantee agencies of what has long been their primary task: reimbursing lenders for defaulted loans.

Currently, guarantee agencies repay lenders for loans that go into default, and the government then repays the guarantee agencies 98 cents per dollar. Guarantee agencies make up the remaining 2 per cent with money they hold in reserve to meet the costs associated with guaranteeing loans.

GOVERNMENT AS 'SOLE INSURER'

Under President Clinton's plan, the government would pay banks the amount of money they lose on federal student loans that are not repaid, making the government the "sole insurer" of guaranteed loans. The plan would require the guarantee agencies to return to the Treasury over five years the \$2.5-billion they now hold in the reserve funds, which, the Administration says, they would no longer need. The loan-programs council has battled the government over whether the agencies have the right to hold this money, which they often use to pay operating expenses.

The changes, Mr. Lief believes, would strip the guarantee agencies of their unique missions, relegating them to being Education Department contractors that can, under another provision of the President's plan, be disposed of at the whim of the Education Secretary.

But to the consternation of Mr. Lief and other guaranteed-loan lobbyists, some of the nation's guarantee agencies have not rejected the President's proposals out of hand.

"There is considerable agreement in terms of the principles we believe in and what the President is espousing," said Jon D. Shaver, executive director of the California Student Aid Commission. "We agree that the reform is needed in the business and financial models of guarantee agencies."

JIM HARRISON FOR THE CHRONICLE

Paul C. Combe: "Our mission should be to keep students from getting into trouble. If we can do that efficiently, it is good for students and for the taxpayers."

Leaders of six guarantee agencies were to meet last week in Sacramento, Cal., to frame a response to the President's proposal. Their statement would be an alternative to that of the national council, which has rejected the President's plan. The agencies involved in the meeting are in California, Massachusetts, Minnesota, New York, Texas, and Wisconsin.

The leaders of those guarantee agencies don't agree with every detail in the President's plan, such as proposed limits on the fees they would receive from the federal government. However, they do agree with the Administration that the current structure and duties that the guarantee agencies perform are outdated.

The rift comes at a delicate time for the guarantee agencies. Over the past five years, the guaranteed-loan program has come under intense criticism from the Education Department, lawmakers, and college leaders, who say it is too complex and cumbersome. More than 1,600 colleges and trade schools, accounting for almost 40 per cent of the nation's student-loan volume, have joined the Clinton Administration's direct-lending program, which provides loan funds directly to colleges, bypassing banks and guarantee agencies.

Of all the partners in the guaranteed-loan program, the guarantee agencies have come under the most fire. This has not escaped the notice of lenders, some of whom have questioned whether the agencies are needed at all.

In this environment, a number of guarantee-agency leaders worry that the agencies will not survive unless they remake themselves, to play a more positive role in the loan program and to end their hostilities with the Education Department.

That is why, they say, they are attracted to some of the President's proposals, which would reward them for performing certain duties that are important to the student-loan program and that will help student borrowers.

PREVENTING DEFAULTS

These leaders support in particular the President's proposal that guarantee agencies become primarily responsible for preventing students from defaulting on their loans. The Administration's proposal would give the Education Department the authority to make agreements with the guarantee agencies to reward them for performing such duties as averting defaults.

Already the department has such a relationship with Wisconsin's Great Lakes Higher Education Corporation, which has been among the strongest supporters of the President's plan. The Administration cites Great Lakes, which altered its structure last year, as a model of how the other guarantee agencies should be revamped.

While the Education Department allows most guarantee agencies to retain 27 per cent of the amount they recover from each loan that goes into default, the department provides bigger rewards to Great Lakes for preventing students from going into default in the first place.

"In the guaranteed-student-loan program, there is a perverse incentive for guarantee agencies to wait to collect loans until after they have gone into default," said Richard H. Johnston, executive vice-president of Great Lakes. "What we should be doing is preventing students from going into default, because once they do, their lives become much more difficult. Their credit history is tarnished."

Mr. Johnston said the incentive had worked. In the first four months of fiscal 1997, Great Lakes saw 16,000 fewer delinquent student borrowers go into default than in the same period in 1996, a decrease of 59 per cent.

Paul C. Combe, president of American Student Assistance Guarantor in Massachusetts, sees value in adopting the default-prevention model that the department has set up with Great Lakes.

"Our mission should be to keep students from getting into trouble," he said. "If we can do that efficiently, it is good for students and for the taxpayers of this country, whose money won't be wasted on paying off defaulted loans."

These guarantee-agency leaders are not troubled that the Administration's plan would end their role of repaying lenders for loans that go into default. In fact, they say, that would not be much of a change.

BAILOUT OF FAILED AGENCY

In 1990, the collapse of the nation's largest guarantee agency, the Kansas-based Higher Education Assistance Foundation, raised tough questions about the soundness of the guaranteed-loan program. At the time, the department was not legally obligated to meet HEAF's obligations to bankers. Many observers worried that if the government did not repay the lenders, the banks would have questioned the dependability of the guarantee system and dropped out of the student-loan business—making loans less available to students.

The federal government bailed out the agency, but lawmakers wanted to prevent any future panic. So during the 1992 reauthorization of the Higher Education Act, Congress approved a provision requiring the government to repay the full value of all defaulted loans if a guarantee agency was unable to do so.

"At that point, the law made it clear that the federal government, and not the guarantee agencies, is the ultimate guarantor of federal student loans," said Mr. Shaver, of the California guarantee agency. "Yet we still operate as if we are."

That view angers Mr. Lief, of the National Council of Higher Education Loan Programs. He worries that by supporting aspects of the President's plan, these agencies could hurt their own program.

He specifically cites proposals to allow the Education Secretary to terminate a guarantee agency if he is not satisfied with its performance.

"They are providing us with no due process," Mr. Lief said. "This will simply further their effort to defeat our program." ■

How to Make College Affordable

No one is talking about the best and cheapest solution

BY NURITH C. AIZENMAN

UNLESS YOUR LAST NAME IS ROCKEFELler, chances are you're unnerved by the sky-rocketing cost of a college education. Perhaps you've heard that between 1981 and 1995, tuition at even traditionally affordable public colleges increased by 234 percent—almost three times as fast as median household income. Not to worry. Help, or rather, the politicians are on the way. President Clinton has introduced a series of measures that, he claims, will make at least the first two years of higher education affordable for everyone. The good news is that Clinton's plan has sparked a spirited debate. Deep thinkers from both ends of the spectrum have come forward with proposals of their own. The bad news is that the most effective—and least costly—solution isn't even being mentioned.

The debaters fall into two camps. On one side are the tax break cheerleaders. Included in this category are hard-right Republicans, who favor a variety of measures—like allowing people to deduct part of the interest on their student loans—that are of dubious benefit unless you happen to be in a high tax bracket. Also in the tax break camp is Bill Clinton, who is touting a less regressive plan. Still, Clinton is hardly mounting a socialist revolution. One of his main proposals, to let families with incomes of up to $100,000 take a tax deduction of up to $10,000 for the cost of higher education, is as generous a gift to the upper middle class as anything the GOP could come up with. To mollify the critics, Clinton has also suggested a tax credit to allow families to keep up to $1500 a year for the first two years of postsecondary school. Since students would have to deduct any federal grant money they receive from the credit, the main beneficiaries would be those in the lower-middle class, who earn too much to qualify for grant assistance, but not enough to really gain from the deduction. The cost of Clinton's tax breaks: $36.2 billion over the next five years.

In the second camp are those who claim federal grants are the way to go. Members of this group include think-tanks like The Institute for Higher Education Policy, which recently co-published a report pointing out that even Clinton's tax credit is of no help to the people who really need it: low-income kids who can't afford to go to college. The meteoric rise in the cost of college, combined with the dramatic decline in government assistance, has hit these kids particularly hard. From 1981 to 1994 the real value of federal "Pell grants" fell by 22 percent. According to economist Thomas Mortenson's analysis of the government's Current Population Survey, today less than 10 percent of kids from low-income families earn a college degree—compared to 80 percent of those in high-income households. Instead of wasting billions of dollars on tax breaks for middle-class students who would go to school anyway, the grant advocates argue, why not spend it on more and larger grants to the neediest students? The Clintonites counter that the point is moot. To ask for anything more than the small Pell grant increase included in Clinton's budget is hopelessly naive, sighs David Longanecker, Assistant Secretary for Postsecondary Education. "We're working with a Congress that doesn't give us that option."

But by framing the issue as a choice between tax breaks or grant increases, Longanecker and the rest ignore a crucial point: there's a third option—one which is far more effective and a whole lot cheaper than either grants or tax breaks. What's more, this plan, or at least a flawed version of it, is already on the books. All that's needed is to get rid of the defects and to implement it properly.

The Third Way

The idea, in its ideal form, is deceptively mundane. Instead of requiring students to pay back their college loans on a fixed schedule, give them the option of taking out long-term loans that are "income-contingent." In other words, the student's monthly repayment is set according to his ability to pay. If his income is low one year, he will pay less back. If he gets a big raise the next year, his payments will go up accordingly. This plan is hardly new: it's been advocated for years by such diverse figures as conservative economist Milton Friedman, and neo-liberal writers Walter Shapiro, Mickey Kaus, and Timothy Noah.

The seemingly simple "pay-as-you-can" formula has enormous potential. And unlike tax breaks or grants, it helps people in all income groups. Working-class students who take out an income-contingent loan will not be forced to repay their debt in impossibly large installments—making them far less likely to default. Middle-class graduates who want to go into useful but low-paying fields, like teaching or social work, will be able to afford that choice. Lower-income kids contemplating college will no longer be discouraged by the fear of taking on a financial burden they might be unable to carry upon graduation. In short, if income-contingent loans were to become widely available, college could become affordable and accessible to everyone. An added bonus: since students would increasingly be the ones paying back their loans, they might be more likely to insist on getting their money's worth, spending less time partying and more time studying, and pushing their schools to reciprocate with lower prices and better quality.

Finally, there's the wonderful boon to taxpayers. Because unlike Clinton's tax breaks, which would set the treasury back $36.2 billion, or grant increases, which would involve additional government spending, a fully implemented income-contingent loan plan would be relatively cheap. The majority of the loans would be financed by the banks. As for the portion financed by the government, the loans would eventually be repaid. Thus the same sum of money could be used over and over again to help successive generations go to college.

How the plan SHOULD work

So what's the best way to make income-contingent loans widely available? Well since these loans may involve long repayment periods that make them potentially less secure and profitable, banks are unlikely to provide them without an incentive. And what better inducement than a little competition from Uncle Sam? By getting into the student-loan business the government would not be attempting to take it over—after all, why use taxpayer money if the banks are willing to do it? Rather, the aim would be to encourage more banks to offer students the pay-as-you-can option and—in the event the banks don't bite—to ensure that all students at least have access to it through the government's program.

There's plenty of precedent here. The Tennessee Valley Authority (TVA), for example, was established in 1933 in part to make cheap electrical power available to the area's inhabitants. The result was to spur nearby private companies, which had been charging twice as much as the TVA, to offer their own customers lower rates.

To prevent borrowers from lying about their income, banks could be allowed to forward cases of suspected cheaters to the IRS for verification. The penalty for fraudulent reporting would be severe. And the IRS could ensure repayment of government loans, as well as defaulted bank ones, by taking the repayments directly out of borrowers' paychecks, as if they were just another tax. That's better than asking people to mail in checks, and helps prevent defaults—not because the IRS has been operating at optimal efficiency lately (it hasn't), but because adding a line or two to the federal income tax form is a lot more effective than other means of collection.

To further sweeten the deal for banks, the government would guarantee income-contingent loans—as it already does with the garden-variety kind. At present about 10.7 percent of students default on their loans. Clinton can be justly proud of the fact that by clamping down on abuse, his administration brought the default rate down from a high of 22.4 percent four years ago. Presumably the pay-as-you-can option would make defaults even more rare—students would have as long as they needed to pay off their debt and, since the average college graduate earns $1.4 million over his lifetime, almost all of them should be able to swing it.

Practice Makes Imperfect

Unfortunately, although an income-contingent loan plan is already on the books—introduced and signed into law by Clinton in 1993—the program has yet to fulfill its potential. That's because both the legislation establishing such loans and the Clinton administration's efforts to implement it have been problematic.

To begin with, Congress kept the IRS out of loan collection. You would think this was the result of a heated argument between our elected officials over the danger of expanding the IRS's power, or the need to protect the sacred confidentiality of taxpayer records. Think again. According to Steven Waldman in his book *The Bill*, the measure was killed because of turf squabbling by committee staffers in the House. The Education and Labor folks worried that involving the IRS would give their counterparts in Ways and Means an excuse to grab the student loan issue. The Ways and Means staffers hated the idea of tinkering with the IRS—and were outraged that they hadn't been consulted about this incursion on their territory. Anxious not to get bogged down, and mindful of the fact that they'd soon be relying on the Ways and Means staff to get the President's economic plan through the House, the administration caved. Who says politicians have all the power?

Petty though it was, this episode had unfortunate consequences. Whether offered by the government or banks, pay-as-you-can loans are unlikely to work unless the IRS is involved. And at this stage in the game, IRS involvement will not be an easy sell. After all, it's the agency everyone—particularly the Republicans who now control Congress—loves to hate. But a firm commitment from the President could go a long way. Instead of criss-crossing the country stumping for tax deductions, Clinton ought to be using his considerable powers of persuasion to explain the benefits of IRS loan collection. After all, the purpose of using the IRS would be to crack down on deadbeats—a point which ought to warm the hearts of hard-line Republicans everywhere.

While he's beating the drum for IRS involvement, Clinton could also talk about the second flaw Congress inflicted on the student loan program. Incorporated into Clinton's original plan was a provision to forgive income-contingent loans 25 years after a student has graduated, regardless of how much he has paid back. Although the 25-year forgiveness option had been floating around for years, the decision to incorporate it was, once again, dictated by staffers and disturbingly free of thoughtful debate. According to Waldman, a 20-year provision was thrown in at the suggestion of aides to Senators Nancy Kassebaum and James Jeffords just before the Senate mark-up—after a discussion of no more than 10 minutes. Later, in conference committee, the amnesty was changed to 25 years—again with minimal consideration.

Proponents of the forgiveness clause maintain that if it's taking someone such a long time to pay off their loan, chances are they are repaying it in installments that are so small they're not even covering the monthly interest on the money they still owe. As a result,

Guaranteed Rip-Off

[illegible]

instead of slowly chipping away at their debt, they are actually building up an ever-larger liability. What's more, anyone who is still in arrears after 25 years would by then be burdened with the additional cost of their children's education, so their debt ought to be forgiven. Ironically, under current law the amnesty hardly provides a free ride: borrowers must pay taxes on the amount that is forgiven, and these can be very high.

But the greatest danger is that by forgiving the loan, the government is, at worst, rewarding irresponsibility, and at best, over-compensating those who are happily pursuing their life's dream without having to worry about paying back the taxpayers who helped them accomplish it. Most importantly, the provision is fundamentally unfair to the folks who work hard to repay their loans before the cut-off.

Long-term loans of say, 35 years, are not without their disadvantages. As anyone with a home mortgage will attest, the longer the term of a loan, the greater the interest that must be paid on it. But just as long-term mortgages democratized home ownership in America, so can long-term student loans democratize higher education. Making those loans income-contingent would increase their impact still further.

As if the 25-year limit on income-contingent government loans were not troublesome enough, the banks face an even more severe restriction: a 10- to 15-year limit on the repayment period of the student loans they can offer. Although Congress took the positive step of requiring banks to give students the choice of income-"sensitive" repayment (the bank version of pay-as-you-can), it left the limit in place. This was a crippling blow, because unless a loan is long-term, repayments on it (income-sensitive or otherwise) can never be made low enough to be widely affordable. Clearly, the 10-year limit must be removed.

Clinton has proposed some remedies, like requiring the banks to offer long term "extended" loans and lifting the 10-year limit on the "graduated" loans banks must now offer. (Under the latter plan the student pays back his loan in gradually increasing installments.) However, Clinton's proposal does not call for any change in the 10-year limit on income-sensitive loans.

...it corporations, these enterprises are some of the most lucrative in America. The largest, part of a company called USA Group, earned over $100 million in tax-free revenues above its expenditures in 1995. USA Group's then-CEO Roy Nicholson got a $1 million salary that year, and its top 6 officials averaged $400,000 a piece. These executives have their offices in the company's sleek $32 million Fishers, Indiana headquarters. And they make large campaign contributions to sympathetic Republicans. *The Baltimore Sun*'s David Folkenflik reports that USA Group executives gave out more than [illegible] in personal contributions in 1994 and almost [illegible] in 1996. The firm has also paid over a million dollars to Washington consultants—all for the purpose of preserving the system which has served it so well. [illegible] fees it charges allow it to provide high quality service and the salaries it pays [illegible] executives who must also run for-profit affiliates. [illegible] raises the question of why guaranty agencies need to be non-profit in the first place. They should either be privatized and forced to offer competitive prices and pay taxes on their profits, or they should be replaced by the IRS, which would simply add loan repayments to the taxes it already collects—eliminating much of the [illegible] percent in overhead the government currently spends to generate student loans. —N.C.A.

A for Effort, C- for Results

That's not the only thing Clinton has done wrong. The administration's well-meaning, but sorely misguided effort to implement the income-contingent loan plan passed by Congress has been equally damaging. The problem is actually two-fold. To begin with, instead of trying to spur banks into offering pay-as-you-can loans by providing them with government competition, the administration has attempted to take over the student loan business altogether. As for the banking industry, it has responded by doing everything in its power to keep the government out. The result has been a stalemate.

The Clintonites' initial reasoning was that the old system of heavily subsidized banking entities [see sidebar] is expensive, enormously complex, and incapable of offering income-contingent loans. The only answer, they decided, was to get rid of the banks and start from scratch. If the government were to become the sole provider of student loans, it would no longer have to waste money on industry subsidies and guarantees. Students would also benefit because the cost of capital is lower for the government than it is for banks and, since it's not out to make a profit, the government could pass all of that savings on to students in the form of lower fees and interest rates. And the system would be more user-friendly for both students and schools—who would only have to deal with one lender, instead of thousands.

But while the administration was right to focus on problems in the old bank system, it was wrong to conclude that the solution is to consign that system to the dustbin. Remember, when the banks make a loan they use their own money—instead of that of taxpayers—so it's a good idea to keep them in the game. The Clintonites also fail to appreciate the value of competition. Not only can it force the banks to offer students better service and more attractive repayment options, but competition is an excellent means of preventing the government from running a sloppy program.

As for the massive subsidies currently paid out to the banking industry, all that's required is for the government to cut out the more outrageous perks, while carefully leaving intact those that are needed to keep the banks in business. Among the indispensable subsidies are those which enable banks to offer students the same low interest rates the government does. In administering these subsidies the government will have to err on the side of caution (or risk driving out the banks). Thus the banks will invariably receive at least a little more than they actually need. That's a necessary evil. However if the banks start taking advantage of the subsidies to undercut the government by offering significantly lower rates, it should be taken as a sign that there's still too much fat.

Sadly, the administration remains determined to replace the banks with "direct" government lending. Initially, it was expected that schools would switch over to the government's more user-friendly program in record numbers. But that was before the newly-elected Republicans in Congress—who were far more sympathetic to the banking industry than their predecessors—voted direct lending out of existence. Even though Clinton vetoed the measure, schools were spooked. If the government's program was in danger of extinction, why change over to it? Particularly since making the switch requires them to adopt a new system of paperwork and computer software.

By now the Clintonites have accepted that, for the foreseeable future, direct and bank lending will coexist. But that doesn't mean the administration has started pushing for the type of competition needed to make the income-contingent plan work. Instead, it is stuck in the old mind-set of competing with the banks to get schools to sign up for direct lending—and assuming that schools can only offer one program. That is the wrong approach. The best way to ensure that students get good service, low rates, and a well-administered pay-as-you-can repayment option is to make the government and the banks compete directly for students' business. For that to happen, every school must be able to offer students both programs.

As a result of the administration's misdirected strategy, income-contingent loans are still not widely available. Although in the 1996 academic year almost 40 percent of students who took out federally guaranteed loans got them directly from the government, it's important to point out that only about 20 percent of schools offer their students such loans. True, after they graduate, students do have the option of consolidating their debt into one pay-as-you-can loan from the government. But the basic problem remains that at almost 80 percent of schools, students are not presented with the income-contingent option when they are first considering whether they can afford to finance their education.

To remedy this situation, the Department of Education must stop trying to convince schools to abandon the bank program and start making it easier for them to add the government's program to their existing mix. The case could be made to schools, which already deal with hundreds of banking entities, that taking on the direct loan program is no harder than adding another bank to their roster—particularly if the department makes its procedures compatible with those of the banks.

The Department must also do a better job of explaining the benefits of income-contingent loans to low-income students. Numerous studies have shown that most low-income students are unwilling to take advantage of government assistance if it comes in the form of loans as opposed to grants. Not surprisingly, they are reluctant to borrow sums that are larger than anyone they know has ever laid eyes on—let alone earned. With the pay-as-you-can option, they will never face repayments that are more than they can afford. But low-income students are unlikely to appreciate that unless a concerted effort is made to educate them about how to make wise use of the income-contingent option. The textbook-style loan handbook currently distributed by the department isn't going to do the trick.

If Clinton really is committed to making higher education affordable for every American, he has much to do: Instead of fighting to get low-income students meager grant increases, he needs to focus on making income-contingent loans available. Instead of defending expensive tax breaks which disproportionately benefit the upper middle class, he needs to lobby for legislative changes—like getting the IRS in on loan collection, lifting the 10-year limit on bank loans, and removing the 25-year amnesty—that are needed to make the pay-as-you-can option viable and fair. A fully implemented income-contingent loan plan offers an incredible opportunity to make higher education widely accessible, without burdening the government with huge expenses. Unfortunately, as long as the issue is framed as a choice between tax breaks and grant increases, the best answer to the college affordability crisis will continue to languish in post-legislative limbo. ●

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To: Bob Shireman

From: John Dean

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Note: Per our discussion re: 1998 interest rates

Transmitted by: ______ **Fax Code:** ______

October 18, 1996

TO: NASFAA Reauthorization Task Force
Attention: Larry Zaglaniczny

FROM: John Dean, Consumer Bankers
Rose DiNapoli, Sallie Mae

SUBJECT: 1998 Interest Rate Change

This memorandum is in follow-up to your discussion with John Dean about the change in the structure of borrower interest rates due to take effect in 1998. As suggested by Ken McInerney, this memo is to provide you with information on this issue which suggests that NASFAA not adopt preliminary recommendation #51.

Legislative Background:

The Higher Education Act provides that, beginning on July 1, 1998, the interest rates on FFELP and Direct Stafford Loans will change from a variable rate based on the 91-Day Treasury Bill to a variable rate based on the "security with the comparable maturity".

1998 Interest Rates May Not Result in Lower Rates for Borrowers:

While maintaining the current Stafford interest rate formula would, according to the most recent CBO estimate, result in an increase of .5% in the rate charged to borrowers, there is no assurance that those projections will be realized. Historically, based on the 10 year period ending in 1993, borrowers would have had lower or equivalent interest rates under the 91-Day T-Bill formula (see attached chart). Interest rates and the relationship between the 10-Year Note and the 91-Day T-Bill (known as the "yield curve") are volatile and are sure to change throughout the life of a given loan. Those who claim that the new rate structure will save borrowers money today must acknowledge the reality that the new rate is just as likely to cost borrowers money tomorrow. Maintaining a low interest rate cap is much more important for borrowers in the long-term than modifying the rate formula.

Formula Change Raises FFELP Administrative Cost:

As we have begun to anticipate this change, we and others in the student lending community are finding serious doubts about this new formula.

FFELP lenders and secondary markets have generally been able to fund their student loan origination and purchases by "matching" the rate on the loans to the debt securities they use to raise the capital they need to make and purchase loans. Currently, there is a broad and active market for debt securities based on 91-Day Treasury Bill rates, enabling lenders to raise sufficient funds to support the necessary $20 billion or more in annual loan originations without assuming undue funding risk.

Lenders and secondary markets in the FFELP have been analyzing how the revised formula will impact generation of capital for the FFELP program. Administrative costs of FFELP lenders and holders would increase with no benefit to borrowers. This analysis is on-going, but rate risk inherent in use of the revised formula will sufficiently complicate generation of capital for FFELP Loans. Some investment advisors working with secondary markets have suggested that raising funds will become more expensive and, for some, impossible.

Recommendation: Adopt a Surer, Simpler Means of Reducing Borrower Costs

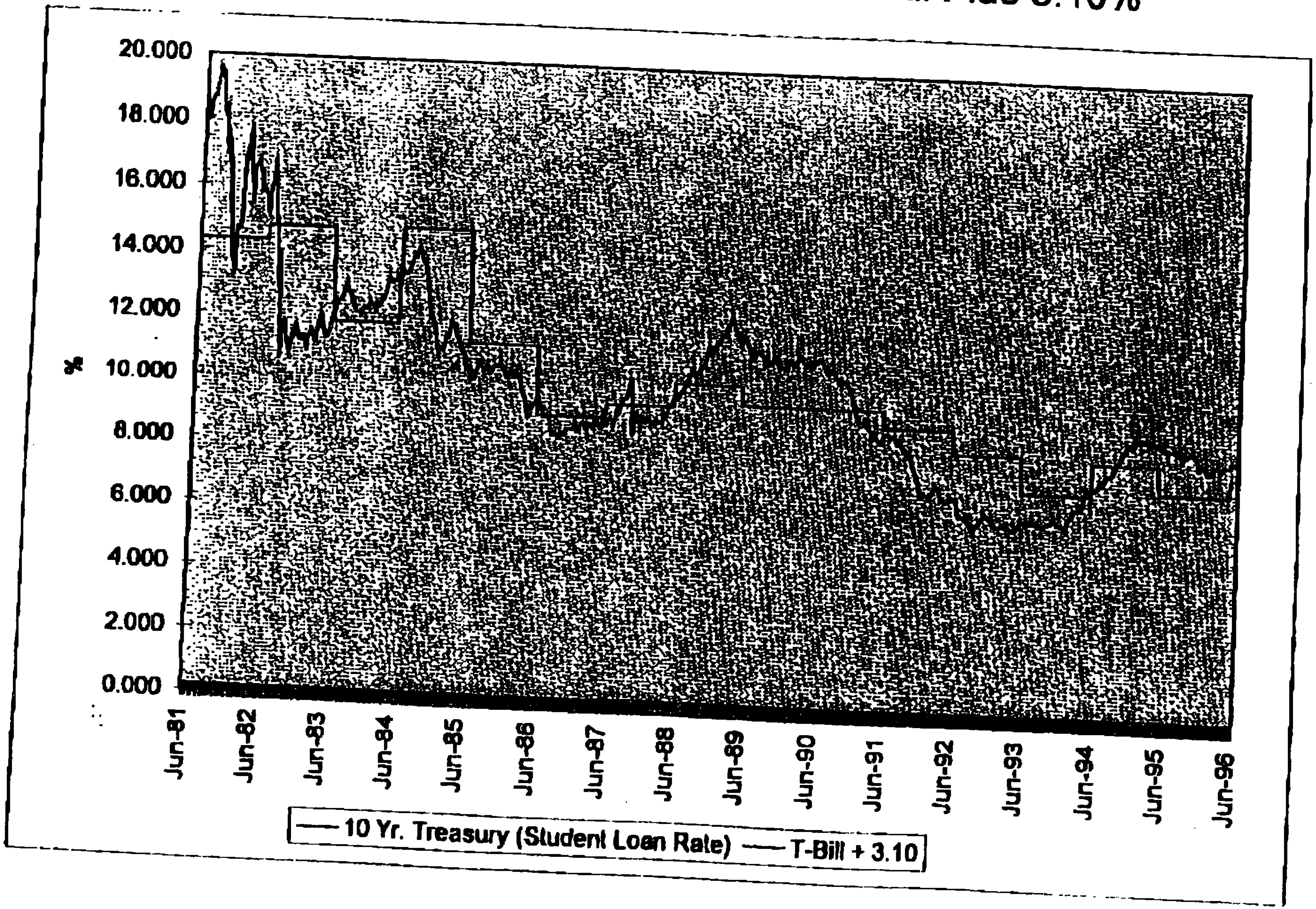
One often overlooked fact about the interest rate change is that deleting the provision could produce significant budget savings. It is our understanding that during FY 96 budget cycle, CBO estimated maintaining the current interest rate structure would result in nearly $2 billion in savings over 7 years. The savings generated could be "spent" for example, to lower the origination fee by 1% for all borrowers -- an item that is a NASFAA priority.

You might also suggest to Congress that it consider lowering the cap on Stafford loans at the same time that it repeals the change in the interest rate formula. In this way, borrowers will be trading a modest increase in projected interest rates over the near-term for long-term protection against high interest rates. This is the same sort of choice made by home-owners when they opt for fixed-rate versus variable rate mortgages, accepting the higher rate so as to be protected from even higher rates in the future. A reduction in the origination fee would eliminate even the near term increase.

Please let us know if you have any questions, or would like to discuss this issue further, we can be reached at (202) 298-3053 (Rose) or (202) 298-3900 (John). We would be happy to provide a personal briefing where we could discuss this issue and possible solutions in greater detail.

Attachments: Charts

Pro -Forma
10 Year Treasury Plus 1.0% vs. T-Bill Plus 3.10%



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85	8.25%	8.25%
86	8.25%	8.22%
87	8.25%	8.25%
88	8.25%	8.25%
89	8.25%	8.25%
90	8.25%	8.25%
91	8.25%	7.70%
92	7.36%	7.89%
93	6.22%	6.79%
94	7.43%	8.25%

5/31 quotes

Date: **August 15, 1996**

Subject **June, 1998, Yield Change Spreadsheets**

Thanks for your interest in these simple calculations. I hope they speak to you and your team. Here are some basic assumptions and thoughts.

- The sheet with pages numbered 1-4 reflects monthly average yields, and some basic calculations, using Bloomberg Financial Services as a source. The column titled "yield curve spread" compares 3-month Bills and 10-year notes. The column titled "credit spread" compares Bills and LIBOR.
- The "Student Loan Yields" section adds applicable spreads to the appropriate index. The "interim difference" column subtracts the proposed "10-year note +1%" rate from the "3-month bill +2.5%. The "repay difference" column compares the repayment status yield with the "10-year note+1% rate".
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- These data include monthly observations from January, 1986 through December, 1995.
- The spreadsheet titled "Impact of 1998 Yield Change ..." summarizes the data from the previous sheet.
- It should be noted that all data here are actual observations, not calculations using raw data. For example, the 1995 High Yield Curve Spread of -0.26% is not calculated by subtracting the High 3-month Bill rate from the High 10-year Note rate (7.58% - 5.99% = 1.59%), but rather by finding the High (narrowest) spread between the two in any one month (November, 1995). This is true for all "calculated" columns.

The conclusions are interesting.

- In 6 of 10 years, interim loan yields are higher under proposed legislation. The same is true In 5 of 10 years using repayment yields.
- Using monthly averages for the entire period, lenders/holders yields are 0.41% higher on interim loans under proposed legislation, but 0.19% lower on repayment loans. The rate differential has an impact.
- ~~The volatility of net interest margin is much greater~~ under the proposed yield change than under current law for interim loans. The respective NIM ranges are from 0.23% to 4.26% on an annual basis, to 1.22% to 2.28%. Monthly variability is even more significant.

I hope this is helpful. I look forward to another discussion of these issues.

08-15-96 12:19PM FROM RETAIL PRODUCT MGMT P02/06

Impact of 1998 Yield Change on Student Loan Yields and Margins

	Market Rates					Student Loan Yields					Net Interest Margin		
	UST Note 10 year	UST Bill 3 month	Libor 3 month	Yield Curve Spread	Credit Spread	10 year UST plus 1.0%	3 month UST plus 2.5%	3 month UST plus 3.10%	Interim Difference	Repay Difference	Proposed 10yr vs LIBOR	Interim 3 mo vs LIBOR	Repay 3 mo vs LIBOR
High	7.58%	5.89%	6.25%	-0.28%	0.49%	8.58%	8.49%	9.09%	0.09%	-0.51%	2.33%	2.30%	2.81%
Low	5.57%	5.07%	5.56%	-1.59%	0.20%	6.57%	7.57%	8.17%	-1.24%	-1.84%	0.93%	2.01%	2.90%
95 Avg.	6.48%	5.62%	5.98%	-0.86%	0.34%	7.48%	8.12%	8.72%	-0.84%	-1.24%	1.52%	2.16%	2.78%
High	7.91%	5.71%	6.43%	-2.14%	0.75%	8.91%	8.21%	8.81%	1.69%	1.09%	3.88%	2.33%	2.93%
Low	5.84%	3.02%	3.19%	-3.19%	0.17%	6.84%	5.52%	6.12%	0.64%	0.04%	2.39%	1.75%	2.35%
94 Avg.	7.12%	4.39%	4.81%	-2.73%	0.42%	8.12%	6.89%	7.49%	1.23%	0.63%	3.31%	2.09%	2.68%
High	6.38%	3.20%	3.44%	-2.34%	0.34%	7.38%	5.70%	6.30%	1.90%	1.30%	4.11%	2.38%	2.98%
Low	5.38%	2.95%	3.13%	-3.40%	0.12%	6.38%	5.45%	6.05%	0.84%	0.24%	3.09%	2.16%	2.76%
93 Avg.	5.84%	3.04%	3.26%	-2.80%	0.22%	6.84%	5.54%	6.14%	1.30%	0.70%	3.58%	2.28%	2.88%
High	7.58%	4.14%	4.29%	-3.24%	0.81%	8.58%	6.64%	7.24%	2.31%	1.71%	4.58%	2.39%	2.98%
Low	6.36%	2.74%	3.06%	-3.81%	0.11%	7.36%	5.24%	5.84%	1.74%	1.14%	4.00%	1.89%	2.49%
92 Avg.	7.02%	3.49%	3.78%	-3.53%	0.27%	8.02%	5.99%	6.59%	2.03%	1.43%	4.26%	2.23%	2.83%
High	8.23%	6.37%	7.00%	-1.64%	0.83%	9.23%	8.87%	9.47%	1.42%	0.82%	3.50%	2.36%	2.96%
Low	6.70%	3.96%	4.25%	-2.92%	0.14%	7.70%	6.45%	7.05%	0.14%	-0.46%	2.01%	1.87%	2.47%
91 Avg.	7.78%	5.49%	5.82%	-2.33%	0.37%	8.78%	7.95%	8.55%	0.83%	0.23%	2.96%	2.13%	2.73%
High	9.02%	8.04%	8.43%	-0.42%	1.05%	10.02%	10.53%	11.14%	-0.05%	-0.65%	1.85%	2.42%	3.02%
Low	8.07%	6.63%	7.56%	-1.44%	0.28%	9.07%	9.13%	9.73%	-1.08%	-1.68%	0.98%	1.45%	2.05%
90 Avg.	8.54%	7.67%	8.19%	-0.87%	0.52%	9.54%	10.17%	10.77%	-0.63%	-1.23%	1.35%	1.98%	2.58%
High	9.30%	9.18%	10.25%	0.30%	1.28%	10.30%	11.68%	12.28%	-1.17%	-1.77%	0.67%	2.04%	2.64%
Low	7.81%	7.77%	8.31%	-0.33%	0.46%	8.81%	10.27%	10.87%	-1.80%	-2.40%	-0.17%	1.22%	1.82%
89 Avg	8.44%	8.39%	9.21%	-0.05%	0.82%	9.44%	10.89%	11.49%	-1.45%	-2.05%	0.23%	1.68%	2.28%
High	9.24%	8.35%	9.55%	-0.79%	1.25%	10.24%	10.85%	11.45%	1.23%	0.63%	2.88%	1.51%	2.11%
Low	8.15%	5.76%	8.75%	-2.72%	0.99%	9.15%	8.26%	8.88%	-0.71%	-1.31%	0.59%	1.25%	1.86%
88 Avg.	8.83%	6.92%	9.00%	-1.91%	1.08%	9.83%	9.42%	10.02%	0.41%	-0.19%	1.83%	1.42%	2.02%
High	9.59%	6.38%	8.19%	-1.43%	2.49%	10.59%	9.28%	9.88%	2.02%	1.42%	2.78%	2.08%	2.88%
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86 Avg.	7.55%	6.08%	6.68%	-1.47%	0.23%	8.55%	8.58%	9.18%	0.03%	-0.63%	1.87%	1.90%	2.50%
86-95 High	9.59%	9.18%	10.25%	0.30%	2.49%	10.59%	11.68%	12.28%	2.31%	1.71%	4.58%	2.42%	3.02%
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86-95 Avgs	7.80%	5.69%	6.28%	-1.91%	0.59%	8.80%	8.19%	8.79%	0.43%	-0.19%	2.32%	1.91%	2.51%

Columns may not "foot" because each cell represents a high or low observation for particular data for that period

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Note: Per our discussion re: 1998 interest rates

Transmitted by: ________ **Fax Code:** ________

October 18, 1996

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FROM: John Dean, Consumer Bankers
Rose DiNapoli, Sallie Mae

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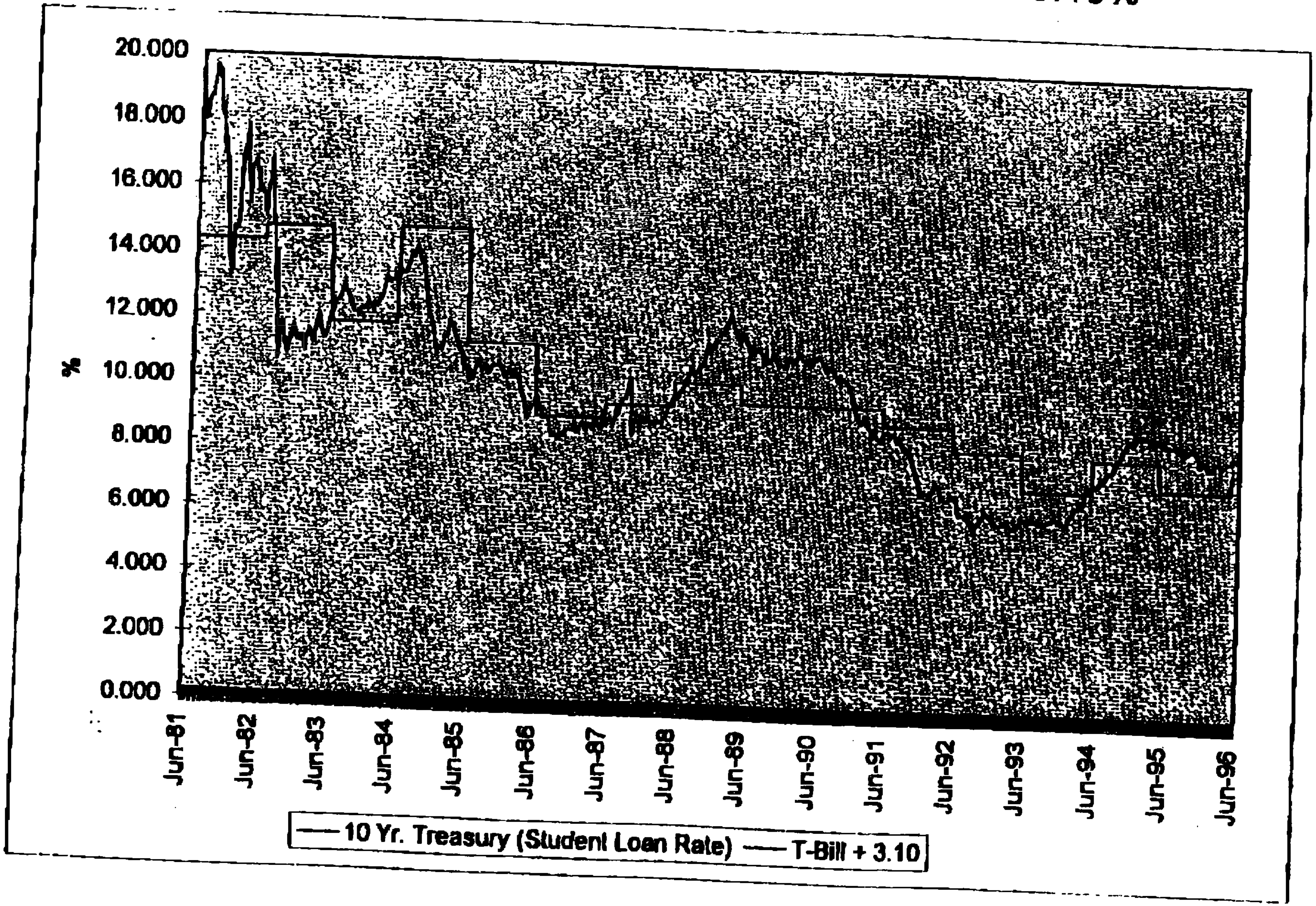
Pro -Forma

10 Year Treasury Plus 1.0% vs. T-Bill Plus 3.10%



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5/31 quotes

Date: August 15, 1996

Subject June, 1998, Yield Change Spreadsheets

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01/10/97 10:37 ☎202 3710137 DBM ☑007

08-15-96 12:19PM FROM RETAIL PRODUCT MGMT P02/06

Impact of 1998 Yield Change on Student Loan Yields and Margins

	Market Rates					Student Loan Yields					Net Interest Margin		
	UST Note 10 year	UST Bill 3 month	Libor 3 month	Yield Curve Spread	Credit Spread	10 year UST plus 1.0%	3 month UST plus 2.5%	3 month UST plus 3.10%	Interim Difference	Repay Difference	Proposed 10yr vs LIBOR	Interim 3 mo vs LIBOR	Repay 3 mo vs LIBOR
High	7.58%	5.89%	6.25%	-0.26%	0.49%	8.58%	8.49%	9.05%	0.09%	-0.51%	2.33%	2.30%	2.61%
Low	5.57%	5.07%	5.56%	-1.59%	0.20%	6.67%	7.57%	8.17%	-1.24%	-1.84%	0.93%	2.01%	2.90%
95 Avg.	6.48%	5.62%	5.98%	-0.86%	0.34%	7.48%	8.12%	8.72%	-0.84%	-1.24%	1.52%	2.16%	2.76%
High	7.91%	5.71%	6.43%	-2.14%	0.75%	8.91%	8.21%	8.81%	1.69%	1.09%	3.86%	2.33%	2.93%
Low	5.64%	3.02%	3.19%	-3.19%	0.17%	6.64%	5.52%	6.12%	0.84%	0.04%	2.39%	1.75%	2.35%
94 Avg.	7.12%	4.39%	4.81%	-2.73%	0.42%	8.12%	6.89%	7.49%	1.23%	0.83%	3.31%	2.08%	2.68%
High	6.38%	3.20%	3.44%	-2.34%	0.34%	7.38%	5.70%	6.30%	1.90%	1.30%	4.11%	2.38%	2.98%
Low	5.38%	2.95%	3.13%	-3.40%	0.12%	6.38%	5.45%	6.05%	0.84%	0.24%	3.09%	2.16%	2.76%
93 Avg.	5.84%	3.04%	3.26%	-2.80%	0.22%	6.84%	5.54%	6.14%	1.30%	0.70%	3.56%	2.28%	2.88%
High	7.58%	4.14%	4.23%	-3.24%	0.81%	8.58%	6.64%	7.24%	2.31%	1.71%	4.58%	2.39%	2.96%
Low	6.36%	2.74%	3.06%	-3.81%	0.11%	7.36%	5.24%	5.84%	1.74%	1.14%	4.00%	1.89%	2.49%
92 Avg	7.02%	3.49%	3.76%	-3.53%	0.27%	8.02%	5.99%	6.59%	2.03%	1.43%	4.26%	2.23%	2.83%
High	8.23%	6.37%	7.00%	-1.64%	0.83%	9.23%	8.87%	9.47%	1.42%	0.82%	3.50%	2.36%	2.96%
Low	6.70%	3.98%	4.25%	-2.92%	0.14%	7.70%	6.48%	7.05%	0.14%	-0.46%	2.01%	1.87%	2.47%
91 Avg.	7.78%	5.45%	5.82%	-2.33%	0.37%	8.78%	7.95%	8.55%	0.83%	0.23%	2.96%	2.13%	2.73%
High	9.02%	8.04%	8.83%	-0.42%	1.05%	10.02%	10.53%	11.14%	-0.05%	-0.65%	1.85%	2.42%	3.02%
Low	8.07%	6.83%	7.56%	-1.44%	0.28%	9.07%	9.13%	9.73%	-1.08%	-1.68%	0.94%	1.45%	2.05%
90 Avg.	8.54%	7.67%	8.19%	-0.87%	0.52%	9.54%	10.17%	10.77%	-0.63%	-1.23%	1.35%	1.98%	2.58%
High	9.30%	9.18%	10.25%	0.30%	1.28%	10.30%	11.68%	12.28%	-1.17%	-1.77%	0.67%	2.04%	2.64%
Low	7.81%	7.77%	8.31%	-0.33%	0.46%	8.81%	10.27%	10.87%	-1.80%	-2.40%	-0.17%	1.22%	1.82%
89 Avg	8.44%	8.39%	9.21%	-0.05%	0.82%	9.44%	10.89%	11.49%	-1.45%	-2.05%	0.23%	1.68%	2.28%
High	9.24%	8.35%	9.56%	-0.79%	1.25%	10.24%	10.85%	11.45%	1.23%	0.63%	2.89%	1.51%	2.11%
Low	8.15%	5.76%	6.75%	-2.72%	0.99%	9.15%	8.26%	8.86%	-0.71%	-1.31%	0.59%	1.25%	1.85%
88 Avg.	8.83%	6.92%	8.00%	-1.91%	1.08%	9.83%	9.42%	10.02%	0.41%	-0.19%	1.83%	1.42%	2.02%
High	9.59%	6.38%	8.19%	-1.43%	2.49%	10.59%	9.28%	9.88%	2.02%	1.42%	2.78%	2.08%	2.68%
Low	7.16%	5.39%	6.19%	-3.52%	0.44%	8.16%	7.89%	8.49%	-0.07%	-0.67%	1.78%	0.01%	0.61%
87 Avg.	8.40%	5.89%	7.16%	-2.52%	1.28%	9.40%	8.38%	8.98%	1.02%	0.42%	2.24%	1.22%	1.82%
High	9.05%	7.22%	8.00%	-0.85%	0.83%	10.05%	9.72%	10.32%	0.61%	0.01%	2.42%	2.27%	2.87%
Low	7.14%	5.27%	5.50%	-2.11%	0.60%	7.92%	7.77%	8.37%	-0.65%	-1.25%	1.04%	1.67%	2.27%
86 Avg.	7.55%	6.06%	6.68%	-1.47%	0.23%	8.56%	8.58%	9.16%	0.03%	-0.63%	1.87%	1.90%	2.50%
86-95 High	9.59%	9.18%	10.25%	0.30%	2.49%	10.59%	11.68%	12.28%	2.31%	1.71%	4.58%	2.42%	3.02%
86-95 Low	5.38%	2.74%	3.06%	-3.81%	0.11%	6.38%	5.24%	5.84%	-1.80%	-2.40%	-0.17%	0.01%	0.61%
86-95 Avgs	7.80%	5.69%	6.28%	-1.91%	0.59%	8.80%	8.19%	8.79%	0.41%	-0.19%	2.32%	1.91%	2.51%

Columns may not "foot" because each cell represents a high or low observation for particular data for that period

December 4, 1996

Edward Eliot Pollack
President and
Chief Executive Officer

Dr. Jon D. Shaver
Executive Director
California Student Aid Commission
PO Box 510845
Sacramento, California 94245-0845

Dear Dr. Shaver:

I recently had the opportunity to review an October draft of the Proposal to Demonstrate and Test an Alternative FFEL Guaranty Agency Business and Financial Model which you created for the California Student Aid Commission. I would like to commend you for a well thought-out and comprehensive analysis. The future of the FFELP depends on such out-of-the box thinking, a willingness to experiment, and close collaboration with colleagues.

While I agree with many of the thoughts and conclusions in your paper, I would like to suggest to you some points for further consideration.

In reviewing the existing guarantor business model, most observers would conclude that both governmental and non-governmental organizations typically are far more effective in serving their customers if they are empowered with flexibility, rather than required to organize around defined cost-centers, each operating on a cost-reimbursement basis. This is especially true when the cost-reimbursement process is defined by a government agency that acts first and foremost as a regulator rather than as a customer service organization, and that has evidenced little interest in enhancing the services provided by those it views as its competitors.

One of the negative features that you attribute to the existing guarantor model is that it *"provides no incentive for efficiency and cost reduction; i.e., all net surplus accrues to the GSLR fund whose ownership is asserted by the federal government."* I strongly disagree with your conclusion in this regard. The existing fee-for-service model -- with guarantors earning revenues only for loans which they guarantee, or prevent from defaulting, or successfully collect -- provides far more incentives for efficiency and cost reduction, as well as for quality customer service, than could ever be obtained with a cost-reimbursement model. USA Funds, and USA Guarantee Services on behalf of its guarantor customers, aggressively work to increase efficiency and lower costs. The extent of the motivation for guarantors to do so can be seen in the recent decisions of the New Mexico Student Loan Guarantee Corporation and the Louisiana Office of Student Financial

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Assistance to contract with USA Group Guarantee Services for the provision of computer systems software and hardware, along with other services. In both of these cases, the guarantors simultaneously lowered their costs and enhanced their abilities to meet the needs of their customers. Clearly, they have a strong incentive to do so.

For USA Funds, the existing funding system, while not ideal, produces a strong incentive to increase efficiency, because we use our net revenues to invest in new customer services that are part of our responsibilities as a guarantor and to continuously enhance the quality of the services we provide to customers. Although we and other guarantors would be better able to serve students, families, and schools if we were not all subject to micro-management by the Department, the fact that the federal government ultimately "owns" the reserve fund does not in and of itself reduce our customer service orientation or our incentives or motivation to innovate, enhance services, and operate efficiently. A cost reimbursement model, however, would do just that, and would turn guarantors into bureaucracies that replicate the government agency that regulates them.

I must also strongly differ on your assertion that *"no significant effort or priority has been placed on default aversion efforts by either the federal government or GA's. Unfortunately, today's financial model pays GA's more for loans that default than it does for loans which do not."*

I encourage a visit by you and members of the Commission to USA Funds to review the extent of the technology and human resources we have devoted to default prevention, the innovations we have introduced, and the procedures and policies we have in place for reviewing the quality of proprietary schools and identifying and restricting the participation of poor quality schools, procedures and policies that we have shared with and that have been adopted by other guarantors. I also suggest that you review materials collected and developed by NCHELP that reveal the extent of the default prevention efforts by all guarantors. I am confident that virtually all guarantors would disagree with your negative assessment of the default prevention efforts of the guarantor community. Unfortunately, the Department and others who wish to undermine the FFELP have made similar charges. It is distressing to learn that a guarantor's executive director has fallen prey to that false argument, and I hope that you will form a different opinion as you become more aware of the activities of other guarantors.

In addition, neither USA Funds nor most, if not all, other guarantors can agree that guarantors are paid more for loans that default than for loans that do not. The only other guarantor that has ever expressed such a view was HEAF, which collapsed financially as a direct result of that conclusion. USA Funds' success in averting approximately 90% of all loans that lenders report to us as seriously delinquent, and the success of other guarantors in preventing default, reflects our belief that guarantors benefit from preventing default, as do our borrower, school, and lender customers, all of whom prefer guarantors that aggressively combat default. I, as well as other guarantors, would be happy to share with you our experience and financial analysis on this subject.

My greatest concern with the cost reimbursement model, which is also favored by the Department, is that it would eliminate the independence of guarantors, thereby eliminating a key strength of the FFELP in comparison to direct lending, and would also eliminate the student and school as customers of the guarantor, replacing them with the Department. Instead of serving the needs of higher education, we would be serving the needs of the Department of Education.

Again, although I disagree on some of the points in your proposal, I appreciate your insight and hope that you will join the rest of the guarantor community in discussing how we can continue to improve the FFELP. The success of the FFELP in serving higher education is highly dependent upon the ability of guarantors to work together cooperatively, especially as we move forward to Reauthorization.

Please let me know if you would like to discuss these issues in person. I look forward to seeing you at the guarantor meeting in Denver later this month.

Sincerely,

Edward E. Pollack

EEP/kb
\nov\11229605

cc: Brett Lief
Larry Matejka
Jane Stewart

Pot

How is this for the weekly report to the Director? — Pat

Good — C. —

There is some wariness both here and at ED about new, lower estimates of defaults on student loans made in previous years. The new estimates, based on a Coopers & Lybrand study, resulted in $3 billion in anticipated reduced costs in the subsidy accounts, all of which show up in the current fiscal year under Credit Reform rules. As was reported in the Washington Post on Thursday, these reestimates were responsible for one-third of the drop in CBO's estimate of the deficit for FY 1997.

The new numbers do make some intuitive sense. Snapshots of borrowers who have been in repayment for two years have shown lower default rates every year for the past few years. In addition, gross default payments have been relatively steady despite significant increases in loan volume. So it makes sense that these trends should bear out in the more detailed analyses of long-term repayment trends, for which estimates have remained constant. Our concern, however, is that we do not have precise information on why the Coopers & Lybrand conclusions differ from the analysis last year by Arthur Andersen, which resulted in no re-estimate of prior-year default rates. (The Department has had great difficulty in estimating default and recovery rates because of the poor quality of the data on the guaranteed student loan program submitted by the guaranty agencies, which administer the guaranteed student loan program for Education. Because of chronic inaccuracies in the data from these agencies, the guaranteed loan program has never received a clean audit.)

ED's Budget Service, in submitting its outlay plan to Treasury last month (which Treasury uses to plan its borrowing), essentially cut in half the downward re-estimate of costs in FY 1997, just to be safe while it evaluates the data in more detail for mid-session review. We have asked ED for a technical analysis of the differences between the two studies.

S. A. Noe

03/20/97 05:09:54 PM

Record Type: Record

To: See the distribution list at the bottom of this message

cc:
Subject: FYI --Shays Hearing

--------------------- Forwarded by S. A. Noe/OMB/EOP on 03/20/97 05:11 PM ---------------------------

Robert_Davidson @ ed.gov
03/20/97 04:12:00 PM

Record Type: Record

To: S. A. Noe

cc:
Subject: Shays Hearing

FYI. The below is from ALan Baldinger of my staff who attended today's Shays Com. hearing. (We had been told by OLCA that it was primarily about GPRA performance measures, as well as SFA/ Direct Loans management. But there was apparently little on GPRA measures.) Bob D.

I attended a House hearing today before the Subcommittee on Human Resources, under the Comittee on Gov't Reform and Oversight.

I stayed for the first panel which consisted of Ed's IG (Tom Bloom)accompanied by Steve McNamara and others, and GAO (Cornelia Blanchette)with several staff including Jay Eglin.

The key topics of this hearing related to Dept management, some GPRA, and what are the challenges facing ED. Direct Loans was also a topic of discussion. After some introductory remarks by chairman Shays (R-Conn), the IG testified. Highlights follow...

Basically, the IG compared ED to a bank because many of the functions are alike. At the same time, Bloom pointed out that a bank is much more of a "technology company" these days. Therefore, ED needs to also operate this way. Bloom cited deficiencies in ED's systems/people that need to be overcome. In response to later questions, Bloom cited the need for a heightened role of the CIO office saying that ED should be using recruiting firms to find a top industry expert, and may have to pay some bucks. Shays acknowledged that such CIO experts often make $250K in the private sector.

Bloom also highlighted the need to distinguish between non-degree granting schools and colleges. Essentially, he made a strong statement that trade schools should be regulated separately and be held to clear performance measures such as what he called "70/70"--at least 70 percent completion rate and 70 percent placement rate in order to be eligible for fed student aid. (Personally, one wonders with all the talk of how much college tuitions have soared, whether they too have feasted at the federal loans table?)

Bloom cited a third major area of need being verification of applicant income via IRS matching. He cited about 4 percent undereporting, but this was not put into any context of what percent undereporting is done on IRS taxes, for instance. Some gross cases of this were highlighted where the Dept does have access to IRS data through income-contingent repayment borrowers. Some borrowers cited minimal income, but IRS matches found those borrowers to be in the $100,000 plus category. According to Bloom, the IRS should be running a match on all recipients of federal money to verify reported income.

GAO pointed out that ED must balance the need to maintain access among all varieties of students and the need to protect federal fiscal interests. GAO's written testimony also cited that the Dept has little performance information on some programs like Title 1, which is the largest single federal elementary and secondary grant program at $7.7 billion in FY97.

In the area of postsecondary student aid, GAO cited their analysis that aid packages with relatively high grant levels may improve low-income students' access to higher education more than packages that rely more on loans. The sooner low-income students receive grant aid, the more likely they are to stay in college. GAO found that $1,000 in additional grant aid reduced dropout probability by 23 percent in the first year and 8 percent in the second year. No effect was seen for the third year. Therefore, GAO argues for greater "frontloading" whereby eligible students would get more grant aid up front and more loans later.

One "Q" from Rep. Snowbarger (R-Ks)was directed at Direct Loans and why the gov't is trying to compete with the private sector. Both GAO and the IG acknowledged that DL has been working well and has spurred improvements in FFEL. The GAO pointed out that Direct Loans actually employs mostly private contractors for servicing because the Dept might not have that expertise. Bloom also noted that guaranty agencies are an area where reform is needed starting with how many do we really need and that the Dept. should have been "riding herd" on them for many years already due to the FFEL data integrity problems.

Nevertheless, both panelists were evasive as to what makes most sense for the future--one program or two. Running two programs indefinitely may not be in the federal fiscal interest and Bloom cites it as another complexity in the student aid arena.

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE GENERAL COUNSEL

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PAT SMITH FAX 395-4875

FROM: LORI TEMPLEMAN

DATE/TIME: 2/18/97 9:45 am

PAGES SENT (including transmittal) 17

COMMENTS: Attached, for OMB's internal use in reviewing our draft student aid budget bill subtitle, are two papers briefly describing the proposal. These are not for review + clearance, but are intended to assist you in your review, since the traditional section-by-section analysis is not prepared when we are part of ~~the~~ a much larger Admin. bill. (The abbreviated section-by-section should be ready by Wednesday 2/19.) We are sending these documents, prepared by Don Feuerstein (re: guaranty agencies) and Lynn Mahaffie (everything else) of the Office of Postsecondary Education because Pat told me Barry was going to require some kind of summaries for his review.

Summary of Student Loan Proposals (Other Than the GA Restructure)

1. Reduce borrower fees by one percent for all borrowers and by two percent for subsidized borrowers.

Current law: Under the FFEL program, a three percent origination fee and a one percent insurance premium are charged to students at the time a loan is originated. Under the Direct Loan program, the Department assesses a four percent loan fee (equivalent to the FFEL origination fee plus the insurance premium) Currently, some FFEL lenders offer fees lower than the statutory maximum to borrowers, but the Department does not have the authority to waive or pay loan fees or offer loan fees that are lower than the statutory maximum.

Proposed change: For loans originated/certified on or after July 1, 1998, eliminate the one percent guaranty agency fee and lower Direct Loan fees by one percent on all loans and reduce origination fees to two percent on subsidized loans in both programs.

Reasons for changes:

1. One percent fee reduction for all loans -- The Administration is striving to provide the best possible benefits to students and families. Lowering required fees by one percent for all loans will provide significant benefits to all students and will provide additional funds to borrowers up front when they need funds to pay tuition. Lowering fees will also help to standardize benefits between the FFEL and Direct Loan programs, because lenders and guaranty agencies will no longer be able to reduce costs for FFEL borrowers by waiving or paying the guaranty agency fee for borrowers.

2. Additional reduction for subsidized loans -- The Administration plans to complement the HOPE scholarship proposal which benefits primarily middle-income students by providing additional student aid benefits to lower-income students. Reducing origination fees an additional one percent for subsidized loans will significantly reduce costs for the neediest students and will provide additional resources to them at the front end of the process.

2. Set in-school interest rate at the ED borrowing rate.

Current law. Beginning October 1, 1997, interest rates on student and PLUS loans will be indexed to the "bond equivalent rate of the security with a comparable maturity." OMB's interpretation of this language is that the interest rate will be indexed to the 10-20 year Treasury rate. In the Direct Loan program, the cost of in-school interest subsidies for Stafford/Ford borrowers is the Department's borrowing rate, currently the 10-20 year Treasury rate. Currently, the rate for student loans made on or after July 1, 1995 is the 91-day Treasury bill rate plus 2.5 percent capped at 8.25 percent. For student loans made after July 1, 1998, the interest rate is the bond equivalent rate of the securities with a comparable maturity plus 1.0 percent during all periods.

Proposed change: Beginning October 1, 1997, the interest rate during in-school, grace, and deferment periods for all Stafford, Stafford/Ford, and unsubsidized loans will equal the Department's borrowing rate (currently, the 10-20 year Treasury rate).

Reason for change: The change will reduce federal costs and provide lower interest rates to borrowers with unsubsidized loans while they are in in-school, grace, and deferment periods. The change also reduces excess profits from the FFEL system by reducing payments to lenders during a time when they have few servicing costs on subsidized loans and the highest profit margins. Finally, the change will standardize interest subsidy payments across the FFEL and Direct Loan programs.

3. Prohibit FFEL lenders from providing different terms to different borrowers.

Current law: Currently, some lenders offer better terms such as interest rates and origination fees that are lower than the statutory maximum to some of their least risky borrowers. Under the Direct Loan program, the Secretary cannot reduce statutory interest rates or fees for any borrower.

Proposed change: For loans originated/certified on or after October 1, 1997, require lenders to offer the same terms and conditions to all of their borrowers within each program (*e.g.*, if a lender offers a reduced interest rate or origination fee to some of its subsidized borrowers, it must offer the same terms to all of its subsidized borrowers).

Reason for change: This change will promote equal costs for all borrowers and ensure that all borrowers served by one lender receive the same benefits regardless of the institution attended or the type of program pursued. This requirement will encourage (but not require) lenders to offer benefits equivalent to those in the Direct Loan program.

4. Provide new repayment plans for FFEL borrowers.

Current law: Currently, many significant differences exist between the Direct Loan and FFEL repayment plans. Direct Loan borrowers may choose among four repayment options, including the standard, income contingent, extended, and graduated repayment plans. In addition, an alternative repayment plan is available to borrowers with exceptional circumstances. Borrowers who choose the extended and graduated repayment plans have up to thirty years to repay their loans, depending upon their loan balances. Direct Loan borrowers may change repayment plans at any time with a few regulatory restrictions

FFEL borrowers may repay their loans under standard, graduated, or income-sensitive repayment plans. However, under all of these plans, borrowers must repay their loans within ten years (excluding periods of deferment and forbearance). Lenders are required to offer graduated and income sensitive repayment plans, but these plans are designed by the individual lenders and vary across the FFEL program. To obtain extended repayment terms (beyond ten years), FFEL borrowers must consolidate their loans.

Proposed change: By October 1, 1997, require FFEL lenders to offer the same extended and graduated repayment plans that are available in Direct Loans and offer alternative repayment in addition to their current standard and income sensitive repayment plans. The parameters of the plans will be outlined in statute, but the specific plans will be determined by the Secretary through regulation. Under current regulation, the repayment period for these loans are up to 30 years depending upon the amount of the debt. The Secretary will be required by statute to make the standard, extended, and graduated repayment plans the same in the Direct Loan and FFEL programs.

The parameters of the extended and graduated repayment plans will be the same parameters that are currently in the Direct Loan statute (*i.e.*, the extended repayment plan would require a fixed annual repayment amount paid over an extended period of time, except that borrowers must pay at least $600 annually, and the graduated repayment plan would require repayment amounts established at two or more graduated levels and paid over a fixed or extended period of time, except that the borrower's scheduled payments will not be less than 50 percent, or more than 150 percent of the required payment under the standard repayment plan). FFEL lenders will be required to offer ten-year income-sensitive repayment plans but will design their own plans as they do now.

The statute will also require lenders to provide alternative repayment arrangements to borrowers who demonstrate that the terms and conditions of the other repayment plans do not accommodate the borrowers' exceptional circumstances. The Secretary will provide regulatory guidelines to lenders regarding the definition of exceptional circumstances and the parameters of alternative repayment plans.

FFEL lenders will be required to offer to borrowers the ability to change repayment plans under the same conditions available to Direct Loan borrowers. These conditions will be determined by regulation. However, the statute will require the conditions to be the same in both programs.

Reason for change: This change will provide increased flexibility to FFEL borrowers, allowing them to determine which repayment plans best suit their individual needs. Providing additional repayment plans to FFEL borrowers eliminates the need for consolidation to obtain extended repayment and may avoid some defaults.

The change will also eliminate the differences between repayment terms in the FFEL and Direct Loan programs to the extent possible. (The Direct Loan income contingent repayment plan will not be available to FFEL borrowers, because lenders will not be able to administer the program in a reliable manner that would not excessively burden lenders and borrowers.) Providing similar repayment options among all lenders and programs will simplify the repayment process for borrowers and will allow financial aid administrators to better counsel borrowers regarding repayment of their loans.

5. Provide the same terms and conditions (except income contingent repayment) on all consolidation loans, and eliminate restrictions on consolidation into Direct Loans.

<u>Current law</u>: Currently, the terms of consolidation are generally more beneficial to borrowers in the Direct Loan program than borrowers in the FFEL program. The statute is very prescriptive regarding the terms of FFEL consolidation loans but provides the Secretary with great discretion regarding the terms and benefits of Direct consolidation loans.

Interest rates -- Section 428C(c)(1) provides that interest rates on FFEL consolidation loans are fixed and are derived from the weighted average of the interest rates of the loans being consolidated rounded up to the nearest whole percent. Section 455(g) gives the Department broad discretion regarding the interest rates on direct consolidation loans. The Department has chosen to offer the variable interest rates determined in section 455(b) on consolidation loans.

In-school consolidation -- In FFEL, borrowers may consolidate loans only during grace and repayment periods. (Currently the definition of eligible borrower in 428C(a)(3) does not allow for consolidation when a borrower is in school.) In Direct Loans, borrowers may consolidate during the in-school period, as provided in regulation, as well as during grace and repayment periods.

Consolidation of consolidation loans -- In FFEL, a borrower may not consolidate a consolidation loan. (Currently section 428C(a)(3)(B)(i) terminates eligibility for an FFEL consolidation loan upon receipt of a consolidation loan. Also, section 428C(a)(4) does not include consolidation loans in the definition of loans eligible for consolidation.) There are no similar restrictions under the Direct Loan program.

Interest subsidy -- In FFEL, a consolidation loan is subsidized only to the extent that all underlying loans are subsidized. If a borrower consolidates a mixture of subsidized and unsubsidized loans, the entire consolidation loan is unsubsidized. (Section 428C(b)(4)(C)(ii) states that interest will be paid by the Secretary on FFEL consolidation loans that consolidate only subsidized Stafford loans and by the borrower in all other cases.) In Direct Loans, a borrower may consolidate subsidized and unsubsidized loans together without losing the subsidy on the underlying subsidized loans.

Restrictions on consolidation into the Direct Loan program -- Currently, a borrower cannot consolidate an FFEL loan into a Direct Loan unless the borrower cannot obtain a consolidation loan with an acceptable income sensitive repayment plan from the borrower's lenders. (See section 428C(b)(5).)

Proposed changes:

1. Provide the same variable interest rates to FFEL consolidation borrowers that are available to Direct Loan borrowers.

2. Allow FFEL borrowers to consolidate their loans while they are in "in-school" status.

3. Allow the consolidation of FFEL consolidation loans into new FFEL consolidation loans.

4. Eliminate the restrictions on consolidating into Direct Loans. The statute will continue to prohibit consolidation of Direct Loans into FFEL loans, because this would be a sale of a government asset, could result in fraud and unscrupulous marketing activities on the part of FFEL lenders, and result in increased costs.

5. Add a provision that would allow borrowers to retain their interest subsidy on the portion of an FFEL consolidation loan that relates to subsidized loans including subsidized consolidation.

Reasons for changes: The proposed changes will reduce costs and provide more flexibility to borrowers who obtain FFEL consolidation loans. This change will extend the favorable terms and conditions of Direct consolidation loans to FFEL borrowers, and will streamline the FFEL process for borrowers with multiple lenders who currently do not consolidate because they do not want to lose benefits. These changes will make the benefits of consolidating in FFEL and Direct Loans more similar.

Specifically:

1. Changing the interest rates provides comparable benefits between FFEL and Direct Loan consolidation programs and reduces the cost to FFEL borrowers by providing more market sensitive interest rates. Currently, many borrowers who would like to deal exclusively with one lender do not consolidate their loans, because it would increase their interest rate. This change would provide a streamlined process for these borrowers, because they will be able to make one monthly payment through consolidation.

2. Allowing in-school consolidation in FFEL provides flexibility to FFEL borrowers to manage their personal loan portfolios. Students with loans from multiple lenders may want to consolidate during the in-school period to reduce the amount of paperwork necessary to obtain a deferment.

3. Allowing consolidation of consolidation loans will provide added flexibility to borrowers who return to school, would like to consolidate loans that were formerly ineligible for consolidation, or neglected to include some loans in the original consolidation. This change will allow these borrowers to deal exclusively with one holder and make only one

monthly loan payment as is permitted in the Direct Loan program. This change diminishes the likelihood of delinquency and default on loans excluded from consolidation.

4. Eliminating restrictions on consolidation into Direct Loans provides additional choices regarding consolidation to FFEL borrowers, particularly for those borrowers who would like to repay their loans under the income contingent repayment plan. It will also reduce burden by eliminating the need for borrowers to attempt to consolidate their loans with their current lenders before consolidating into Direct Loans.

5. Allowing FFEL borrowers to retain the interest subsidy on the underlying subsidized loans when they consolidate provides a financial benefit to borrowers who would like to make one monthly loan payment on all their loans and promotes equal benefits in the Direct Loan and FFEL programs.

6. Compute special allowance rates at the same time and in the same manner as student interest rates.

Current law: Special allowance rates and payments are computed and paid to lenders quarterly under section 438. The basis for special allowance rates is the average Treasury bill auction of the quarter.

Proposed change: Beginning October 1, 1997, for all new loans, compute rates of special allowance annually rather than quarterly based on the last Treasury bill auction of the year. Payments will continue to be made quarterly based on the annual rate.

Reason for the change: The purpose of special allowance payments is to assure lenders a fair return on student loans. Special allowance payments guarantee that lenders will earn market rate interest even though student rates are capped. Currently, student interest rates are determined annually, and the special allowance rates are computed quarterly. Additionally, interest rates are reset on the basis of the last Treasury bill auction of the year, while special allowances are calculated on the basis of the average auction results during the quarter. These mismatches create the possibility that special allowance will be paid even though the lender is already receiving the prescribed spread. The proposed change will require the calculation of special allowance and student interest rates at the same time and in the same manner thereby eliminating the "partial floor" windfall for lenders.

Summary of ED Proposal for Restructuring FFELP Guaranty Agencies as Part of Reconciliation

1. Current Law

A State or private nonprofit agency for each State has been designated by the Secretary to guarantee FFELP loans for all schools in the State and for all resident students attending schools elsewhere. The guarantees are issued by the guaranty agencies in their own names but are 98-percent reinsured by the Secretary. In addition to guaranteeing FFELP loans, the agencies are expected to track the guarantees and provide timely and accurate reports on them to the Secretary, prevent default of delinquent loans referred to them by lenders, review default claims, make claims payments, collect defaulted loans, review schools and lenders for compliance with the HEA and the Secretary's regulations and provide information and assistance to borrowers, schools and lenders.

The revenues of the guaranty agencies are (1) a guaranty fee from borrowers not to exceed 1 percent; (2) an administrative expense allowance (AEA) from the Secretary, currently set at 0.85 percent of new guaranty volume (not to exceed $152 million in aggregate); (3) a supplemental preclaims allowance from the Secretary at 1 percent of the value of delinquent loans referred by lenders and not defaulting within a specified period; (4) a 27-percent retention on collections of defaulted loans and (5) investment earnings.

The guaranty agencies were initially funded with Federal advances, of which $38 million have not previously been recalled. Since the two largest components of their revenues are based on new volume, and new volume has consistently grown since the guaranty agencies were established, the agencies have accumulated some $2.1 billion in net revenues and continue to accumulate them at the rate of some $200 million per year. These net revenues constitute their reserve funds and are clearly established by case law and statute as Federal property. As long as the volume of new guarantees does not decrease drastically, the guaranty agencies can fund the cost of maintaining their outstanding guarantees and their 2-percent risk-sharing from their current revenues without resorting to their reserves.

When a loan becomes delinquent, the lender is required to refer it to the guaranty agency for preclaims assistance; that is, assistance in trying to get the borrower to start or resume making timely payments. Initially, the guaranty agency does not receive any additional revenue for its efforts. If the loan remains delinquent for more than a specified period, the loans enters supplemental preclaims assistance and is eligible for the 1-percent fee if it does not default within a further specified period. But no actual payment by the borrower is required for the guaranty agency to earn this additional revenue. If the loan does subsequently default, the guaranty agency attempts to collect it on the Secretary's behalf and is entitled to the much larger 27-percent retention fee, regardless whether it does so internally or utilizes a debt collector or other outside contractor..

2. Serious Deficiencies in the Current Structure

Over the years, a number of serious deficiencies have been identified in the current structure for guaranty agencies:

a. Guarantor function: The current funding of guaranty agencies is based upon a purported guarantor function. In fact, the Secretary rather than the guaranty agencies assumes all the insurance risk through a combination of reinsurance and excess Federal funding, and there is no reason for the agencies to maintain reserves against future defaults. This focus upon an illusory guarantor function deflects attention from the guaranty agency's actual role in administering a Federal guarantee, and the need to protect the Federal fiscal interest in unnecessary reserves diverts valuable Federal regulatory resources. The irrationality of the current guaranty-agency structure undermines the integrity and efficiency of FFELP.

b. Economic incentives: On a function-by-function basis, the current revenues of guaranty agencies are unrelated to the costs associated with the performance of those functions or to the quality of that performance. In particular, both the current guaranty fee and AEA are front-ended and based on loan size, while expenses are incurred throughout the life of the guaranty and are based on the number of guarantees or active accounts. Thus, guaranty agencies are incentivized to maximize their new volume regardless of its ultimate economics. On an aggregate basis, the exclusive use of reserve funds for FFELP and DL provides no financial incentive for a guaranty agency to maximize its economic efficiency or the quality of its service.

c. Regulatory authority: In the absence of appropriate economic incentives, the Secretary must rely entirely upon regulatory authority to obtain high-quality, economically efficient performance from the guaranty agencies. In fact, however, once a guaranty agency has been designated by the Secretary, its status becomes virtually an entitlement. The Secretary's authority to terminate that status is not sufficiently related to the quality of the agency's operational performance; and the procedure required is cumbersome and protracted. Although the Secretary also has authority to take adverse financial action against a

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guaranty agency, poorly performing agencies frequently have no funds of their own, and such actions can only be satisfied with their Federal reserve funds.

d. Default prevention/collection: In the interest both of students and of the Government, the prevention of defaults should a prime priority of guaranty agencies. The current financial incentive for guaranty agencies to perform that crucial function, the supplemental preclaims allowance, is earned by the guaranty agency merely by delaying an eventual default and without any borrower payment and is vastly overshadowed by the collection retention if the exact same result is achieved immediately after default. Although it is possible for people of good will to overcome such a perverse set of incentives, there is no countervailing benefit from having it. The cost structure for internal default prevention/collection activities is much less than for external activities performed by a collection agency or other external contractor. The Department's cost for external collection activities is only 18.5 percent; and in the absence of special circumstances, the Department can utilize contractors for this function as efficiently as guaranty agencies. Basing the revenue for default prevention/collection on the size of the loan incentivizes the guaranty agencies to emphasize the economic implications of borrower defaults over their human costs.

3. Proposed New Structure

Effective October 1, 1997, the structure of guaranty agencies is proposed to be changed as follows:[1]

a. Guarantees. The guaranty agencies would issue all new guarantees as the agents of the Secretary and in the Secretary's name, rather than their own. They would continue to maintain the guarantees, now also as agents of the Secretary. All outstanding guarantees would be superceded by direct Federal guarantees to the extent that the guaranty agencies' reserve funds had been legally committed, and the agencies would be relieved of any further contractual liability on them to that extent. There would be no risk-sharing by the guaranty agencies or adverse economic consequences simply because of high default rates. (See i, below for noncompliance with regulatory or contractual requirements.) When borrowers default, the Secretary would the

[1] The proposed budget assumes effectiveness for the full FY98. GLOS estimates that any portion of the new structure for which changes in regulations are not necessary could be implemented in six months. The guaranty agencies will also need time to decide whether to continue in FFELP and to adjust to the new structure. The Secretary should have authority to implement interim measures to effect the restructuring.

pay lenders directly after review of their claims by the guaranty agencies. Until a system for direct payment can be implemented, the guaranty agencies would continue to disburse claims payments on the Secretary's behalf, but the Secretary would advance the funds for those payments in order not to require the guaranty agencies to hold increased working capital in order to finance the negative float under the current reimbursement structure.

b. Selection/retention. All existing agreements between the Secretary and guaranty agencies would be replaced by performance-based agreements conforming to their new role as third-party servicers. These agreements would be for 5-year terms (roughly corresponding to reauthorization cycles). The agreements would (1) terminate automatically for failure to meet a demand from the Secretary for recall or Federal reserves (see c, below) or termination of any other agreement with the Secretary, (2) could be terminated at any time by the Secretary without an opportunity for a hearing in the event of bankruptcy, insolvency, legal inability to perform legal and contractual obligations to the Secretary or losses for more than one year and (3) could be terminated by the Secretary at any time with an opportunity a hearing for substantial failure to meet the performance standards set forth in the agreements (see i, below). Upon expiration, termination or resignation, the Secretary would be authorized to designate by agreement any State or non-profit agency as the new guaranty agency. At that time, the Secretary would alternatively be authorized to contract with any other entity, including for-profits, for any or all of the services performed by the former guaranty agency.

c. Reserve funds and assets/capitalization. Guaranty agencies would no longer be indefinitely capitalized by the Secretary. The Secretary would be authorized to recall all existing reserve funds to the Department of the Treasury, subject to the following limitations: (1) In accordance with the President's overall budget for FY98-02, the minimum amounts to be recalled during that period would be \$731 million in FY98, \$127 million in FY99, \$186 million in FY00, \$186 million in FY01 and \$1.271 billion in FY02. (2) Recalls would be allocated among the guaranty agencies in proportion to their FYE97 reserve funds. (3) Until the end of FY02, agencies designated by agreement with the Secretary would be allowed to retain an aggregate of \$350 million, allocated among them in proportion to their number of outstanding accounts, as interim working capital. To preclude dissipation of any other unrecalled reserves, the reserves and, after FY98, any income earned on them would be required to be invested in Government securities specified by the Secretary, which might be transferred to the Treasury at par value to satisfy any recall requirement. The guaranty agencies would be prohibited from using these restricted accounts for any other purpose. Other reserve fund assets, such as buildings and equipment, might still be used by the guaranty agencies, although they would remain the property of the United States, and would be subject to recall upon cessation of an agency's agreement with the Secretary. Contractors would be required to provide their own working capital.

4. Revenues. The Secretary's agreements with guaranty agencies would provide a one-time issuance fee for each new guaranty (net of cancellations) and an annual maintenance fee for each outstanding borrower account. The fees would be (1) uniform for all guaranty agencies; (2) based on numbers of loans and accounts, rather than dollar amounts; (3) designed to yield at least the same group-aggregate revenue as the FY97 appropriations formula for AEA (without the cap)[2] and (4) paid quarterly. Other sources of revenue would be (1) a default-avoidance fee paid by lenders (see f, below), (2) a collections retention (see h, below), (3) interest on working capital and (4) other FFELP-related businesses, such as lender escrow and third-party servicing, previously purchased or developed with reserve funds and allowed by the agencies' agreements with the Secretary on an agency-by-agency basis. The current administrative expense allowance and payments for supplemental preclaims assistance would be eliminated. The revenues of contractors would be determined by their contracts.

e. Net revenues. Any unrestricted net revenues earned by restructured guaranty agencies designated by agreement with the Secretary from activities under those agreements would be the property of the United States but might be used as working capital for those activities. To provide an incentive for guaranty agencies to be economically efficient, net revenues projected to be in excess of the agencies' working-capital needs might, with the Secretary's approval of projected working-capital needs and proposed usages, also be used to fund need-based grant programs or other activities in support of postsecondary education. Upon cessation of an agency's agreement, all remaining funds would be returned to the Secretary. Any net revenues earned by contractors would be their own.

f. Default prevention. This would be one of the most important functions of restructured guaranty agencies. Lenders would continue to refer delinquent loans to them as they do under current law. If the guaranty agency succeeded in getting a loan current, including consolidations, the lender would pay it a fee set by the Secretary but not to exceed $100 per account for avoiding a potential co-insurance cost of 5 percent. Since large-balance loans are already more likely to be collectible than others, a fixed dollar fee would avoid double-biasing the system against the default prevention of other loans. The

[2]The current budget projections for AEA are $153 million for FY98, $146 million for FY99, $144 million for FY00, $149 million for FY01 and $153 million for FY02.

Secretary would have discretionary authority to provide by regulation the circumstances under which refunds of those fees by the guaranty agencies would be required for loans that subsequently default.

g. Claims payment. The Secretary would have authority to pay claims directly to lenders after review by the guaranty agencies. To minimize the need for working capital until a system for direct payments could be put in place, guaranty agencies would be allowed to submit claims immediately after review.

h. Collections. The collections retention for defaults, which would also be applicable to consolidations, would be reduced to a rate set by the Secretary but not to exceed 18.5 percent. Since the collections-retention rate applies both to high-cost external collections activities and low-cost internal collections activities, it could make some external activities by the guaranty agencies uneconomic and be overly profitable for many internal activities. Accordingly, the Secretary would use the new authority to set the retention rate and existing authorities to subrogate defaulted loans and to alter guaranty agency entitlements by mutual agreement so as to eliminate perverse incentives for guaranty agencies to reduce the cost of defaults to the Government.

i. Additional performance incentives/disincentives. Like contracts, guaranty agency agreements would contain specific performance standards, including the submission of timely and accurate data to the Department; and an annual performance audit, based on a statistically valid sample, would be required. Performance results would be measured across agencies on a comparable basis and publicly released. Since there would no longer be reinsurance that could be lost for due diligence or other performance failures, guaranty agencies would be required to indemnify the Secretary from any economic loss caused by their performance failures. The Secretary would also have the power to fine guaranty agencies for performance failures.

4. Economic Model

The level of funding in the restructuring proposal has been designed to sustain the current average expense ratios of the guaranty agencies and allow agencies operating at or below the average to replenish their working capital by FYE02 and possibly generate a surplus. The funding model is displayed in Table I. Table II displays reported expense ratios for FY95 and indicates how individual guaranty agencies might fare under the proposal.[3]

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[3]The table is based on unreviewed data for FY95 submitted by the guaranty agencies. FY96 data is not yet available. The data

Substantial improvement by the less efficient agencies, if they do improve, or increased economies of scale through consolidation, if they do not, should result in substantial aggregate cost reductions.

5. [redacted]

Third-party servicers would still be necessary to perform the actual issuance and maintenance of Federal guarantees, as well as the other functions currently performed by guaranty agencies. There has not yet been sufficient experience with the servicing of direct loans to determine whether some or all of these functions are better performed (1) under contract by for-profit entities as well as by the State and private non-profit agencies currently eligible to be guaranty agencies or (2) only by those currently eligible under regulatory performance-based agreements. Particularly for those functions such compliance review and provision of information and assistance, entities with general responsibility for post-secondary education may be better motivated than for-profit entities. Accordingly, the Secretary proposes to continue using the current regulatory arrangements to compare results with those in direct loans. The new arrangements would be much more performance-based than at present, however; and guaranty agencies would no longer have a virtual entitlement to continue their designations. The default-prevention fee and default-collection retention are inherently performance-based, and the Secretary would be authorized to restructure the issuance and maintenance fees if ways could be devised better to link them to the quality of the agencies' performance of those functions, also. In addition, the Secretary would have new authority to obtain some or all of these functions by contracts.

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are based on the agencies' own allocations of expenses between collections and other activities, which GLOS has frequently found to be unreliable.

TABLE I

Calculation of GA Operating Revenues and Expenses

GA Activity					
	1998	1999	2000	2001	2002
Cash on Hand (BOY)	2,391,389,000	421,880,156	426,133,479	455,505,567	498,889,429
Collections					
Collections on defaulted loans	534,125,900	397,191,300	279,166,000	287,268,800	297,904,800
Remittance to ED	-435,312,608	-323,710,910	846,221,534	-234,124,072	-242,792,412
Collection Costs	-85,841,662	-55,065,158	1,045,825,224	1,045,014,944	1,043,951,344
Net Revenue as a Result of Collection Activity	12,971,629	18,415,233	23,729,110	24,417,848	25,321,908
Other Activity					
Issuance Fee Revenue	105,692,852	96,557,211	93,741,338	97,162,547	100,689,817
Maintenance Fee Revenue	82,509,801	78,941,602	74,453,337	71,941,314	69,222,106
Subtotal Issuance and Maintenance Fees	188,202,654	175,498,813	168,194,674	169,103,861	169,911,923
Issuance and Maintenance Fees from Direct Federal Payments	152,143,000	147,985,000	147,207,000	153,860,000	163,585,000
Issuance and Maintenance Fees Paid from Restricted Activity Account	36,059,654	27,513,813	20,987,674	15,243,861	6,326,923
Investment Income from Working Capital	116,301,213	20,527,337	20,734,290	22,183,442	24,274,362
Lender paid SPCA	102,618,000	107,104,000	110,851,000	112,648,000	113,308,000
Other Revenues	15,000,000	15,000,000	15,000,000	15,000,000	15,000,000
Issuance Expenses	-152,550,017	-135,838,325	-128,540,422	-129,660,907	-131,170,465
Maintenance Expenses	-210,663,323	-196,453,735	-180,596,565	-170,088,382	-159,518,868
Net Revenue as a Result of Other Activity	58,908,527	-14,161,910	5,642,978	18,966,014	31,804,952
Receipt of Working Capital (EOY)	350,000,000	0	0	0	0
Payment to Restricted Activity Account (EOY)	-2,391,389,000	0	0	0	723,741,824
Cash on Hand (EOY)	421,880,156	426,133,479	455,505,567	498,889,429	206,016,289
Restricted Activity Account					
	1998	1999	2000	2001	2002
Balance (BOY)	0	1,274,329,346	1,194,285,657	1,053,604,550	908,773,488
Reserve Activity					
Payment from GAs	2,391,389,000	0	0	0	350,000,000
Interest on Restricted Activity Account	0	74,470,123	60,300,560	56,412,790	40,165,730
Issuance and Maintenance Support	-36,059,654	-27,513,813	-20,987,674	-15,243,861	-6,326,923
Working Capital Outlay	723,741,824	0	0	0	0
Recall of Reserves	-731,000,000	946,741,824	687,741,824	887,741,824	-1,271,000,000
Net Revenue as a Result of Reserve Activity	1,274,329,346	-80,043,689	-140,681,107	-144,831,063	-879,141,193
Balance (EOY)	1,274,329,346	1,194,285,657	1,053,604,550	908,773,488	29,632,295
Assumptions					
Maintenance Expense per Outstanding Account	12.00	11.70	11.40	11.11	10.83
Issuance Expense per Guaranty	34.64	33.76	32.91	32.08	31.27
Rate of Return on Working Capital Investment	4.78%	4.78%	4.78%	4.78%	4.78%
Rate of Return on Restricted Account Investment	6.11%	5.72%	5.44%	5.25%	5.20%
Number of New Gross Commitments (non Consol)	4,403,869	4,073,717	3,905,889	4,048,439	4,195,409

Number of Outstanding Accounts	17,555,277	16,796,086	15,841,135	15,308,663	14,728,108
Total Outstanding Volume for GAs	115,299,227,280	116,175,587,080	114,820,649,720	113,829,885,580	112,356,363,500
Maintenance Fee Payment per Outstanding Account	4.70	4.70	4.70	4.70	4.70
Insurance Fee Payment per Guaranty	24.00	24.00	24.00	24.00	24.00
Average Collection Cost Percentage	16.1%	13.9%	10.0%	10.0%	10.0%

TABLE II

Guaranty Agency Expense Ratios for FY95

AGENCY	ISSUANCE EXPENSE RATIO[4]	MAINTENANCE EXPENSE RATIO[5]
ALABAMA	2.90%	0.31%
ARKANSAS	1.53%	0.39%
CALIFORNIA	1.05%	0.23%
COLORADO	2.76%	0.50%
CONNECTICUT	0.48%	0.07%
FLORIDA	0.70%	0.22%
GEORGIA	1.53%	0.35%
ILLINOIS	1.97%	0.25%
IOWA	1.31%	0.20%
KENTUCKY	0.25%	0.07%
LOUISIANA	0.91%	0.26%
MASSACHUSETTS	1.14%	0.27%
MICHIGAN	1.64%	0.30%
MINNESOTA	0.45%	0.13%
MISSOURI	0.64%	0.13%
MONTANA	1.29%	0.35%
NEBRASKA	1.30%	0.22%
NEW HAMPSHIRE	0.97%	0.29%
NEW JERSEY	1.58%	0.22%
NEW MEXICO	1.28%	0.34%
NEW YORK	1.18%	0.24%
NORTH CAROLINA	0.28%	0.07%
NORTH DAKOTA	1.16%	0.28%
OHIO	1.38%	0.23%
OKLAHOMA	1.28%	0.35%
OREGON	1.19%	0.20%
PENNSYLVANIA	0.68%	0.15%
RHODE ISLAND	0.57%	0.17%
SOUTH CAROLINA	0.27%	0.08%
SOUTH DAKOTA	1.89%	0.52%
TENNESSEE	0.63%	0.15%
TEXAS	0.90%	0.28%
USAF	0.66%	0.18%
UTAH	0.70%	0.20%
VERMONT	1.12%	0.29%
VIRGINIA	2.29%	0.43%
WASHINGTON	1.11%	0.31%
WISCONSIN	0.87%	0.20%
AGGREGATE	0.96%	0.22%

[4] 50 percent of expenses, excluding collections expenses, divided by new volume.

[5] 50 percent of expenses, excluding collections expenses, divided by original principal amount of outstanding guarantees.

FINAL

SUBTITLE B—STUDENT FINANCIAL AID PROVISIONS

SHORT TITLE; REFERENCES

SEC. 6101. (a) SHORT TITLE.—This subtitle may be cited as the "Student Financial Aid Improvements Act of 1997".

(b) REFERENCES.—References in this subtitle to "the Act" refer to the Higher Education Act of 1965 (20 U.S.C. 1001 *et seq.*).

MANAGEMENT AND RECOVERY OF RESERVES

SEC. 6102. (a) Section 422 of the Act is amended—

(1) by amending subsection (g)(1) to read as follows:

"(1) AUTHORITY TO RECOVER FUNDS.—(A) Notwithstanding any other law, the reserve funds of the guaranty agencies, and any assets purchased or developed with those reserve funds, regardless of who holds or controls the reserves or assets, shall remain the property of the United States.

"(B) The Secretary may direct the guaranty agency to require the return, to the guaranty agency or to the Secretary, of any reserve funds or assets held by, or under the control of, any other entity, that the Secretary determines are required—

"(i) to pay the program expenses and contingent liabilities of the guaranty agency;

"(ii) to satisfy the guaranty agency's

requirements under subsection (h); or

"(iii) for the orderly termination of the guaranty agency's operations and the liquidation of its assets.

"(C) The Secretary may direct a guaranty agency, or the agency's officers or directors, to cease any activity involving expenditure, use, or transfer of the guaranty agency's reserve funds or assets that the Secretary determines is a misapplication, misuse, or improper expenditure of those funds or assets."; and

(2) by adding after subsection (g) the following new subsections:

"(h) <u>RECALL OF RESERVES IN FISCAL YEARS 1997 THROUGH 2002; LIMITATIONS ON USE OF RESERVE FUNDS AND ASSETS</u>.—(1)(A) Notwithstanding any other law, the Secretary shall, except as otherwise provided in this subsection, recall from the reserve funds held by guaranty agencies (which for purposes of this subsection shall include any reserve funds held by, or under the control of, any other entity) not less than—

"(i) $731,000,000 in fiscal year 1998;

"(ii) $127,000,000 in fiscal year 1999;

"(iii) $186,000,000 in each of the fiscal years 2000 and 2001; and

"(iv) $1,271,000,000 in fiscal year 2002.

"(B) Funds returned to the Secretary under this subsection shall be deposited in the Treasury.

"(C) The Secretary shall require each guaranty agency to return reserve funds under subparagraph (A) based on its proportionate share, as determined by the Secretary, of all reserve funds held by guaranty agencies as of September 30, 1996.

"(2)(A) Within 45 days of enactment of this subsection, all reserve funds held by a guaranty agency that have not yet been recalled by the Secretary under paragraph (1) shall be transferred by the guaranty agency to a restricted account (of a type specified by the Secretary) established by the guaranty agency, and be invested in United States Government securities specified by the Secretary. The manner and timeframe in which reserve funds so invested are recalled shall be specified by the Secretary, consistent with the requirements of this subsection. Except as described in subparagraph (B), the guaranty agency shall not use the reserve funds in the account, including the earnings on those funds, for any purpose without the express permission of the Secretary.

"(B)(i) In order to assist guaranty agencies in meeting program expenses, the Secretary shall permit the use of not more than an aggregate of $350,000,000 of the reserve funds held in the restricted accounts described in subparagraph (A) by guaranty agencies with agreements under section 428(c), as working capital to be used for purposes the Secretary may specify. The Secretary shall specify the amount of reserve funds in each guaranty agency's restricted account that may be used as working capital, based on the guaranty agency's proportionate share of all borrower accounts outstanding on September 30, 1996. The guaranty agency shall repay that amount to its restricted account (or returned to the Treasury, if so directed by the Secretary) by no later than September 30, 2002, or the date on which the agency's agreement under section 428(c) ends (through resignation, expiration, or termination), whichever is earlier.

"(ii) The guaranty agency may use the earnings from its restricted account for fiscal year 1998 to assist in meeting its operational expenses for such year.

"(C) Non-liquid reserve fund assets, such as buildings and equipment purchased or developed by the guaranty agency with reserve funds, and any liquid assets remaining in a guaranty agency's restricted account after the recalls in paragraph (1)(A), shall—

"(i) remain the property of the United States;

"(ii) be used only for such purposes as the Secretary determines are appropriate; and

"(iii) be subject to recall by the Secretary no later than the date on which such agency's agreement under section 428(c) ends (through resignation, expiration, or termination, as the case may be).".

REPAYMENT TERMS

SEC. 6103. (a) Section 427 of the Act is amended—

(1) in subsection (a)(2)—

(A) in subparagraph (B), in the matter preceding clause (i), by striking "over a period" through "nor more than 10 years" and inserting "in accordance with the repayment plan selected under subsection (d),";

(B) in subparagraph (C), at the end of the subparagraph, by striking "the 10-year period described in subparagraph (B);" and inserting the following: "the length of the repayment period under a repayment plan described in subsection (d);";

(C) by striking subparagraph (F);

(D) by redesignating subparagraphs (G), (H), and (I) as subparagraphs (F), (G), and (H), respectively; and

(E) in subparagraph (G) (as redesignated by subparagraph (D)), by striking "the option" through the end of the subparagraph and inserting "the repayment options described in subsection (d); and";

(2) in subsection (c), by striking "in subsection (a)(2)(H)," and inserting the following: "by a repayment plan selected by the borrower under subparagraph (C) or (D) of subsection (d)(1),"; and

(3) by adding after subsection (c) the following new subsection:

"(d) REPAYMENT PLANS.—(1) DESIGN AND SELECTION.—In accordance with regulations of the Secretary, the lender shall offer a borrower of a loan made under this part the plans described in this subsection for repayment of such loan, including principal and interest thereon. No plan may require a borrower to repay a loan in less than five years. The borrower may choose from—

"(A) a standard repayment plan, with a fixed annual repayment amount paid over a fixed period of time, not to exceed ten years;

"(B) an extended repayment plan, with a fixed annual repayment amount paid over an extended period of time, not to exceed 30 years, except that the borrower shall repay annually a minimum amount determined in accordance with subsection (c);

"(C) a graduated repayment plan, with annual repayment amounts established at 2 or more graduated levels and paid over an extended period of time, not to exceed 30 years, except that the borrower's scheduled payments shall not be less than 50 percent, nor more than 150 percent, of what the amortized payment on the amount owed would be if the loan were repaid under the standard repayment plan; and

"(D) an income-sensitive repayment plan, with income-sensitive repayment amounts paid over a fixed period of time, not to exceed ten years.

"(2) <u>LENDER SELECTION OF OPTION IF BORROWER DOES NOT SELECT</u>.—If a borrower of a loan made under this part does not select a repayment plan described in paragraph (1), the lender shall provide the borrower with a repayment plan described in paragraph (1)(A).

"(3) <u>CHANGES IN SELECTIONS</u>.—The borrower of a loan made under this part may change the borrower's selection of a repayment plan under paragraph (1), or the lender's selection of a plan for the borrower under paragraph (2), as the case may be, under such conditions as may be prescribed by the Secretary in regulation.

"(4) <u>ACCELERATION PERMITTED</u>.—Under any of the plans described in this subsection, the borrower shall be entitled to accelerate, without penalty, repayment on the borrower's loans under this part.".

(b) Section 428(b) of the Act is amended—

(1) in paragraph (1)—

(A) in subparagraph (D), by striking clauses (i) and (ii) and the clause designation "(iii)";

(B) in subparagraph (E)—

(i) in clause (i)—

(I) by striking "or section 428A," and inserting "or section 428H,"; and

(II) by striking "the option" through the end of the clause and inserting "the repayment options described in paragraph (9); and"; and

(ii) in clause (ii)—

(I) by striking "over a period" through "nor more than 10 years" and inserting "in accordance with the repayment plan selected under paragraph (9), and"; and

(II) by striking "of this subsection;" at the end of clause (ii) and inserting a semicolon; and

(C) in subparagraph (L)(i), by inserting after the clause designation the following: "except as otherwise provided by a repayment plan selected by the borrower under paragraph (9)(A)(iii) or (iv),"; and

(2) by adding after paragraph (8) the following new paragraph:

"(9) <u>REPAYMENT PLANS</u>.—(A) <u>DESIGN AND SELECTION</u>.—In accordance with regulations of the Secretary, the lender shall offer a borrower of a loan made under this part the plans described in this subparagraph for repayment of such loan, including principal and interest thereon. No plan may require a borrower to repay a loan in less than five years. The borrower may choose from—

"(i) a standard repayment plan, with a fixed annual repayment amount paid over a fixed period of time, not to exceed ten years;

"(ii) an extended repayment plan, with a fixed annual repayment amount paid over an extended period of time, not to exceed 30 years, except that the borrower shall repay annually a minimum amount determined in accordance with paragraph (2)(L);

"(iii) a graduated repayment plan, with annual repayment amounts established at 2 or more graduated levels and paid over an extended period of time, not to exceed 30 years, except that the borrower's scheduled payments shall not be less than 50 percent, nor more than 150 percent, of what the amortized payment on the amount owed would be if the loan were repaid under the standard repayment plan; and

"(iv) an income-sensitive repayment plan, with income-sensitive repayment amounts paid over a fixed period of time, not to exceed ten years.

"(B) LENDER SELECTION OF OPTION IF BORROWER DOES NOT SELECT.—If a borrower of a loan made under this part does not select a repayment plan described in subparagraph (A), the lender shall provide the borrower with a repayment plan described in subparagraph (A)(i).

"(C) CHANGES IN SELECTIONS.—The borrower of a loan made under this part may change the borrower's selection of a repayment plan under subparagraph (A), or the lender's selection of a plan for the borrower under subparagraph (B), as the case may be, under such conditions as may be prescribed by the Secretary in regulation.

"(D) ACCELERATION PERMITTED.—Under any of the plans described in this paragraph, the borrower shall be entitled to accelerate, without penalty, repayment on the borrower's loans under this part.

"(F) COMPARABLE FFEL AND DIRECT LOAN REPAYMENT PLANS.—The Secretary shall ensure that the repayment plans offered to borrowers under this part are comparable, to the extent practicable and not otherwise provided in statute, to the repayment plans offered under part D.".

(c) Section 428C of the Act is amended—

(1) in subsection (b)(3)(F), by striking "alternative"; and

(2) in subsection (c)—

(A) by amending paragraph (2) to read as follows:

"(2) <u>REPAYMENT PLANS</u>.—(A) <u>DESIGN AND SELECTION</u>.—In accordance with regulations of the Secretary, the lender shall offer a borrower of a loan made under this section the plans described in this paragraph for repayment of such loan, including principal and interest thereon. No plan may require a borrower to repay a loan in less than five years. The borrower may choose from—

"(i) a standard repayment plan, with a fixed annual repayment amount paid over a fixed period of time, not to exceed ten years;

"(ii) an extended repayment plan, with a fixed annual repayment amount paid over an extended period of time, not to exceed 30 years, except that the borrower shall repay annually a minimum amount determined in accordance with paragraph (3);

"(iii) a graduated repayment plan, with

annual repayment amounts established at 2 or more graduated levels and paid over an extended period of time, not to exceed 30 years, except that the borrower's scheduled payments shall not be less than 50 percent, nor more than 150 percent, of what the amortized payment on the amount owed would be if the loan were repaid under the standard repayment plan; and

"(iv) an income-sensitive repayment plan, with income-sensitive repayment amounts paid over a fixed period of time, not to exceed ten years.

"(B) LENDER SELECTION OF OPTION IF BORROWER DOES NOT SELECT.—If a borrower of a loan made under this section does not select a repayment plan described in subparagraph (A), the lender shall provide the borrower with a repayment plan described in subparagraph (A)(i).

"(C) CHANGES IN SELECTIONS.—The borrower of a loan made under this section may change the borrower's selection of a repayment plan under subparagraph (A), or the lender's selection of a plan for the borrower under subparagraph (B), as the case may be, under such conditions as may be prescribed by the Secretary in regulation.".

(d) Section 455(d) of the Act is amended—

(A) in paragraph (1)—

(i) in subparagraph (B), by inserting after "an extended period of time," the following: "not to exceed 30 years,"; and

(ii) in subparagraph (C), by striking "a fixed or extended period of time," and inserting the following: ""an extended period of time, not to exceed 30 years,"; and

(B) in paragraph (2), by striking "subparagraph (A), (B), or (C) of paragraph (1)." and inserting "paragraph (1)(A).".

INTEREST RATES

SEC. 6104. (a) Section 427A of the Act is amended—

(1) in subsection (g)(2)—

(A) by inserting after the paragraph heading the subparagraph designation "(A)";

(B) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively;

(C) by striking "paragraph (1)," and inserting "paragraph (1), and except as provided in subparagraph (B),"; and

(D) by adding after subparagraph (A) (as redesignated by subparagraph (A)) the following new subparagraph:

"(B) In the case of loans made or insured under section 428 or 428H for which the first disbursement is made on or after October 1, 1997, for purposes of paragraph (1), the rate determined under this paragraph shall, during any 12-month period beginning on July 1 and ending on June 30, be determined on the preceding June 1 and be equal to the bond equivalent rate of the securities with a comparable maturity, as established by the Secretary, except that such rate shall not exceed 8.25 percent.";

(2) in subsection (h)—

(A) in the heading thereof, by striking "JULY 1, 1998.—" and inserting "OCTOBER 1, 1997.—";

(B) in paragraph (1)—

(i) by striking "(f), and (g)" and inserting "and (f),"; and

(ii) by striking "July 1, 1998," and inserting "October 1, 1997,"; and

(C) in paragraph (2)—

(i) in the heading, by striking "JULY 1, 1998.—" and inserting "OCTOBER 1, 1997.—"; and

(ii) by striking "July 1, 1998," and

inserting "October 1, 1997,"; and

(3) in subsection (i)(7)(B), by adding at the end the following: "Notwithstanding any other provision of law, the interest rate determined under this subparagraph shall be used solely to determine the rebate of excess interest required by this paragraph and shall not be used to calculate or pay special allowances under section 438.".

(b) Section 455(b) of the Act is amended—

(1) in paragraph (2)(B)—

(A) by redesignating clauses (i) and (ii) as subclauses (I) and (II), respectively;

(B) by inserting after the subparagraph heading the clause designation "(i)";

(C) by striking "subparagraph (A)," and inserting "subparagraph (A) and except as provided in clause (ii),"; and

(D) by adding after clause (i) (as redesignated by subparagraph (B)) the following new clause:

"(ii) In the case of Federal Direct Stafford/Ford Loans or Federal Direct Unsubsidized Stafford/Ford Loans for which the first disbursement is made on or after October 1, 1997, for purposes of subparagraph (A), the rate determined under this subparagraph shall, during any 12-month period beginning on July 1 and ending on June 30, be determined on the preceding June 1 and be equal to the bond equivalent rate of the securities with a comparable maturity, as established by the Secretary, except that such rate shall not exceed 8.25 percent.";

(2) in paragraph (3)—

(A) by striking "and (2)," and inserting ", and except as provided in paragraph (2),"; and

(B) by striking "made on or after July 1, 1998," and inserting "for which the first disbursement is made on or after October 1, 1997,"; and

(3) in paragraph (4)(B), by striking "July 1, 1998," and inserting "October 1, 1997,".

LENDER AND HOLDER RISK SHARING

SEC. 6105. Section 428(b)(1)(G) of the Act is amended by striking "not less than 98 percent" and inserting "95 percent".

FEES AND INSURANCE PREMIUMS

SEC. 6106. (a) Section 428(b)(1)(H) of the Act is amended—

(1) by inserting the clause designation "(i)" following the subparagraph designation;

(2) by striking "the loan," and inserting "any loan made under section 428 or 428B before July 1, 1998,"; and

(3) after clause (i) (as redesignated by paragraph (1)), by adding "and" and the following new clause:

"(ii) provides that no insurance premiums shall be charged to the borrower of any loan made under section 428 or 428B on or after July 1, 1998;".

(b) Section 428H(h) of the Act is amended—

(1) by inserting the paragraph designation "(1)" following the subsection heading;

(2) by striking "under this section" and inserting "of a loan made under this section made before July 1, 1998"; and

(3) by adding at the end of paragraph (1) (as redesignated by paragraph (1)) the following new paragraph:

"(2) No insurance premium may be charged to the borrower on any loan made under this section made on or after July 1, 1998.".

(d) Section 438(c) of the Act is amended—

(1) in paragraph (2), by striking "paragraph (6)" and inserting "paragraphs (6) and (8)"; and

(2) by adding after paragraph (7) the following new paragraph:

"(8) ORIGINATION FEE ON SUBSIDIZED LOANS ON OR AFTER JULY 1, 1998.—In the case of any loan made, insured or guaranteed under section 428 on or after July 1, 1998, paragraph (2) shall be applied by substituting '2.0 percent' for '3.0 percent'.".

(e) Section 455(c) of the Act is amended—

(1) by striking "The Secretary" and inserting "(1) For

loans made under this part before July 1, 1998, the Secretary";

(2) by striking "of a loan made under this part"; and

(3) by adding at the end thereof the following new paragraph:

"(2) For loans made under this part on or after July 1, 1998, the Secretary shall charge the borrower an origination fee of—

"(i) 2.0 percent of the principal amount of the loan, in the case of Federal Direct Stafford/Ford Loans; or

"(ii) 3.0 percent of the principal amount of the loan, in the case of Federal Direct Unsubsidized Stafford/Ford Loans or Federal Direct PLUS Loans.".

FUNCTIONS OF GUARANTY AGENCIES

SEC. 6107. (a) Section 428 of the Act is further amended—

(1) in subsection (a)—

(A) in paragraph (1)(B)—

(i) in the matter preceding clause (i), by striking "which is insured" and inserting "which, before October 1, 1997, is"; and

(ii) in clause (ii), by inserting "as in effect the day before the day of enactment of this section," after "subsection (b),"; and

(B) in paragraph (3)—

(i) by striking subparagraph (B); and

(ii) in subparagraph (A)—

(I) in clause (ii), by striking "under any" through the end of the clause and inserting a period;

(II) by striking the subparagraph designation "(A)";

(III) by redesignating clauses (i) and (ii) as subparagraphs (A) and (B), respectively; and

(IV) by redesignating subclauses (I) and (II) as clauses (i) and (ii), respectively;

(2) in subsection (b)—

(A) by amending the heading to read as follows: "REQUIREMENTS TO QUALIFY LOANS FOR INSURANCE AND INTEREST SUBSIDIES.—";

(B) in paragraph (1)—

(i) by amending the heading to read as follows: REQUIREMENTS.—";

(ii) by amending the matter preceding subparagraph (A) to read as follows: "A loan by an eligible lender shall be insurable by the Secretary, and students who receive such loans shall be entitled to have made on their behalf the payments provided for in subsection (a), under a program of student loan insurance that—";

(iii) by amending subparagraph (K) to read as follows:

"(K) provides that the holder of any such loan will be required to submit to the Secretary, at such time or times and in such manner as the Secretary may prescribe, statements containing such information as may be required by regulation for the purpose of enabling the Secretary to determine the amount of the payment which must be made with respect to that loan;";

(iv) by amending subparagraph (O) to read as follows:

"(O) provides that, if the sale, assignment, or other transfer of a loan made under this part to another holder will result in a change in the identity of the party to whom the borrower must send subsequent payments or direct any communications concerning the loans, then—

"(i) the transferor and the transferee shall be required, not later than 45 days from the date the transferee acquires a legally enforceable right to receive payment from the borrower on such loan, either jointly or separately to provide a notice to the borrower of—

"(I) the sale, assignment, or other transfer;

"(II) the identity of the transferee;

"(III) the name and address of the party to whom subsequent payments or communications must be sent; and

"(IV) the telephone numbers of both the transferor and the transferee; and

"(ii) the transferee shall be required to notify the Secretary, and, upon the request of an institution of higher education, the Secretary shall notify the last such institution the student attended prior to the beginning of the repayment period of any loan made under this part, of—

"(I) any sale, assignment, or

other transfer of the loan; and

"(II) the address and telephone number by which contact may be made with the new holder concerning repayment of the loan;

"except that this subparagraph shall apply only if the borrower is in the grace period described in section 427(a)(2)(B) or 428(b)(7) or is in repayment status.";

(v) in subparagraph (Q), by striking "guarantee" and "428A" and inserting "insurance" and "428H", respectively;

(vi) by amending subparagraph (R) to read as follows:

"(R) provides for the making of such reports, in such form and containing such information, including financial information, as the Secretary may reasonably require to carry out the Secretary's functions under this part and protect the financial interest of the United States, and for keeping such records and for affording such access thereto as the Secretary may find necessary to ensure the correctness and verification of such reports;";

(vii) by amending subparagraph (S) to read as follows:

"(S) provides that a lender shall pay a default prevention fee in accordance with subsection (g);

(viii) in subparagraph (T)—

(I) in clause (i), by inserting ", by the guaranty agency, in accordance with regulations prescribed by the Secretary," after "limitation"; and

(II) in clause (ii)—

(aa) in the matter preceding subclause (I), by inserting ", in accordance with regulations prescribed by the Secretary," after "institution";

(bb) by striking subclauses (I) and (II); and

(cc) redesignating subclauses (III), (IV), and (V) as subclauses (I), (II), and (III), respectively;

(ix) by amending subparagraph (U) to read as follows:

"(U) provides—

"(i) for such additional criteria concerning the eligibility of lenders described in section 435(d)(1) as may be permitted by the Secretary; and

"(ii) an assurance that the guaranty agency will report to the Secretary concerning changes in criteria under clause (i), including any procedures in effect under such program to take emergency action, limit, suspend, or terminate lenders; and"; and

(x) by striking subparagraphs (V), (W), and (X);

(C) by amending paragraph (2) to read as follows:

"(2) SKIP-TRACING REQUIREMENT.—In the case of a default claim based on an inability to locate the borrower, a lender shall certify to the Secretary, at the time of submission of the default claim, that diligent attempts have been made to locate the borrower through the use of reasonable skip-tracing techniques in accordance with regulations prescribed by the Secretary.";

(D) in paragraph (3)(B), by striking the parenthetical through the end of of the subparagraph and inserting a period; and

(E) by amending paragraph (5) to read as follows:

"(5) COMPLIANCE AUDITS.—(A) Except as

provided in subparagraph (B) or by the Single Audit Act Amendments of 1996, an eligible lender that originates or holds more than $5,000,000 in loans made under this title during an annual audit period shall submit to the Secretary a compliance audit for that audit period which is conducted by a qualified, independent organization or person in accordance with the Government Auditing Standards issued by the Comptroller General, and the regulations of the Secretary.

"(B) The Secretary may permit a lender to submit the results of an audit conducted for other purposes if the Secretary determines that such other audit results provide the same information as required under subparagraph (A).";

(3) in subsection (c)—

(A) by amending the heading to read as follows: "<u>AGREEMENTS WITH GUARANTY AGENCIES</u>.—";

(B) in paragraph (3)—

(i) in the matter preceding subparagraph (A), by striking "A guaranty agreement" and inserting "An agreement between the Secretary and a guaranty agency"

(ii) in the flush left language at the end of the paragraph, by striking "Guaranty agencies" and inserting "The Secretary"; and

(iii) by redesignating paragraph (3) as paragraph (11);

(C) by striking paragraphs (1), (2), (4), and (5);

(D) by inserting after the subsection heading the following new paragraphs:

"(1) AUTHORITY TO ENTER INTO AGREEMENTS.—(A)(i) The Secretary may enter into an agreement with a guaranty agency, under which the Secretary shall insure loans made under this section through the guaranty agency as the agent of the Secretary.

"(ii) Any guaranty agency that had an agreement with the Secretary under section 428(b) as of the day before the date of enactment of the Balanced Budget Act of 1997 may enter into an initial agreement with the Secretary under this subsection.

"(iii) An agreement under this subsection shall be five years in duration, and may be renewed by the Secretary for successive five-year periods.

"(iv) The Secretary may terminate the agreement prior to its expiration in accordance with paragraph (9).

"(2) EFFECT ON PRIOR GUARANTY AGREEMENTS AND LOAN INSURANCE BY GUARANTY AGENCIES.—(A) All guaranty agreements made under this subsection as it was in effect on the day before the date of enactment of the Balanced Budget Act of 1997 shall terminate not later than 180 days after the date of enactment of that Act.

"(B) Notwithstanding any other provision of law—

"(i) to the extent that a guaranty agency had insured loans under this part, loan insurance by such guaranty agency that is outstanding as of the date of the termination under subparagraph (A) shall be replaced on such date by loan insurance issued by the Secretary, and the guaranty agency shall be relieved of any further liability thereon;

"(ii) the Secretary's liability for any outstanding liabilities of a guaranty agency (other than outstanding loan insurance under this part), shall not exceed the fair market value of the unrestricted funds of the guaranty agency, which shall consist of—

"(I) all accumulated earnings not otherwise placed in a restricted account in accordance with section 422(h)(2)(A); and

"(II) any working capital that may be provided under section 422(h)(2)(B); and

"(iii) for the first year after the date of enactment of the Balanced Budget Act of 1997, the Secretary may specify such interim administrative measures as the Secretary determines to be necessary for the efficient transfer of the loan insurance function, and to carry out the purposes of this part.

"(3) TERMS OF AGREEMENT.—The agreement between the Secretary and a guaranty agency shall include, but not be limited to—

"(A) provisions regarding the responsibilities of the guaranty agency for—

"(i) administering the issuance of insurance on loans made under this section on behalf of the Secretary;

"(ii) monitoring insurance commitments made under this section;

"(iii) default prevention activities;

"(iv) review of default claims made by lenders;

"(v) payment of default claims;

"(vi) collection of defaulted loans;

"(vii) adoption of internal systems of

accounting and auditing that are acceptable to the Secretary, and reporting the result thereof to the Secretary on a timely, accurate, and auditable basis;

"(viii) timely and accurate collection and reporting of such other data as the Secretary may require to carry out the purposes of the programs under this title;

"(ix) monitoring of institutions and lenders participating in the program under this part; and

"(x) such other program functions as the Secretary may require of the guaranty agency;

"(B) provisions regarding the fees the Secretary shall pay to the guaranty agency under the agreement, and other revenues that the guaranty agency may receive thereunder, as described in paragraphs (4) and (6);

"(C) provisions requiring the guaranty agency to carry out its responsibilities under the agreement in accordance with paragraph (5);

"(D) provisions regarding the use, in accordance with paragraph (10), of net revenues in excess of the guaranty agency's need for working capital, as determined after compliance with section 422(h), for such other activities in support of postsecondary education as may be agreed to by the Secretary and the guaranty agency;

"(E) provisions regarding such other businesses, previously purchased or developed with reserve funds, that relate to the program under this part and in which the Secretary permits the guaranty agency to engage (as determined on a case-by-case basis);

"(F) provisions setting forth such administrative and fiscal procedures as may be necessary to protect the United States from the risk of unreasonable loss thereunder, and to ensure proper and efficient administration of the loan insurance program;

"(G) provisions regarding the submission of the results of audits of the guaranty agency that are conducted—

"(i) at least annually;

"(ii) by a qualified, independent organization or person in accordance with the standards established by the Comptroller General for the audit of governmental organizations, programs, and functions; and

"(iii) in accordance with the regulations of the Secretary;

"(H) provisions requiring the making of such reports, in such form and containing such information, including financial information, as the Secretary may reasonably require to carry out the Secretary's functions under this part and to protect the Federal fiscal interest, and for keeping such records and for affording such access thereto as the Secretary may find necessary or appropriate to ensure the correctness and verification of such reports;

"(I) adequate assurances that the guaranty agency will not engage in any pattern or practice which may result in a denial of a borrower's access to loans under this part because of the borrower's race, sex, color, religion, national origin, age, handicapped status, income, attendance at a particular eligible institution, length of the borrower's educational program, or the borrower's academic year in school;

"(J) assurances that—

"(i) upon the request of an eligible institution, the guaranty agency shall, subject to clauses (ii) and (iii), furnish to the institution information with respect to students (including the names and addresses of such students) who received loans made or insured under this part for attendance at the eligible institution and for whom preclaims assistance activities have been requested under subsection (l);

"(ii) the guaranty agency shall require the payment by the institution of a reasonable fee (as determined in accordance with regulations prescribed by the Secretary) for such information; and

"(iii) the institution may use such information only to remind students of their obligation to repay student loans and may not disseminate the information for any other purpose; and

"(K) such other provisions as the Secretary may determine to be necessary to protect the United States from the risk of unreasonable loss and to promote the purposes of this part.

"(4) FEES AND OTHER REVENUES.—(A)(i) The Secretary shall pay to a guaranty agency with an agreement under this subsection the following uniform fees:

"(I) a one-time issuance fee for each new loan made under this part that is insured by the Secretary through the guaranty agency; and

"(II) an annual maintenance fee for each active borrower account.

"(ii) The fees described in clause (i) shall be paid from the funds available under section 458(a) on a quarterly basis, in such amount as the

Secretary determines, for all guaranty agencies with agreements under this subsection.

"(B) A guaranty agency with an agreement under this subsection also may receive revenues derived from—

"(i) a default prevention fee paid by lenders in accordance with subsection (g);

"(ii) the collection retention allowance under paragraph (6);

"(iii) the interest earned on working capital provided under section 422(h);

"(iv) such other businesses, previously purchased or developed with reserve funds, that relate to the program under this part and in which the Secretary permits the guaranty agency to engage (as determined on a case-by-case basis); and

"(v) such other fees as may be authorized under this part.

"(5) PERFORMANCE REQUIREMENTS.—(A) A guaranty agency with an agreement under this subsection shall carry out its responsibilities thereunder in accordance with such measurable performance-based standards as the Secretary may specify, and shall submit timely and accurate data to the Secretary in support of its performance.

"(B) The Secretary shall apply the performance standards uniformly to guaranty agencies with agreements under this subsection.

"(C) The Secretary shall assess the performance of each guaranty agency on the basis of the audits required under paragraph (3)(G), and shall compare such guaranty agency's performance against the performance of other such guaranty agencies and publicly disseminate such comparison.

"(D) The Secretary may impose a fine, in accordance with the terms of the agreement, on a guaranty agency that fails to achieve a specified level of performance on one or more performance standards. If the guaranty agency's failure to achieve such performance level results in a financial loss to the United States, the guaranty agency shall indemnify the Secretary for such loss.";

(E) by amending paragraph (6) to read as follows:

"(6) <u>COLLECTION RETENTION ALLOWANCE</u>.—(A) If, after the Secretary has paid a claim on a loan made under this title, any payments are made in discharge of the obligation incurred by the borrower with respect to such loan (including any payments of interest accruing on such loan after the payment of the default claim by the Secretary), there shall be paid over to the Secretary that portion of the payments remaining after the guaranty agency with which the Secretary has an agreement under this subsection has deducted from such payments an amount for costs related to the student loan insurance program that—

"(i) shall be specified by the Secretary on the basis of the Secretary's review of payments for similar services in a competitive environment; and

"(ii) in no case shall exceed 18.5 percent of such payments (subject to subparagraph (B)).

"(B) If, after the Secretary has paid a claim on a loan made under this title, and the liability on such loan is discharged by payment of the proceeds of a consolidation loan under this part or under part D, the guaranty agency may not deduct the amount specified in subparagraph (A), but may charge the borrower an amount specified by the Secretary and not to exceed 18.5% of the principal amount of the defaulted loan at the time of consolidation, to defray the guaranty agency's collection costs on the defaulted loan to be consolidated.";

(F) by amending paragraph (7) to read as follows:

"(7) <u>SECRETARY AUTHORIZED TO RENEW OR MAKE ALTERNATE AGREEMENTS</u>.—Notwithstanding any other provision of law, once the initial agreement with a guaranty agency entered into after the date of enactment of the Balanced Budget Act of 1997 has ended (through its expiration, the termination of the guaranty agency agreement by the Secretary in accordance with paragraph (9), or the resignation of the guaranty agency, as the case may be), the Secretary, in his discretion, may enter into—

"(A) another agreement with the guaranty agency;

"(B) an alternate agreement under which the functions previously performed by the guaranty agency shall be performed by another State or private nonprofit agency with which the Secretary has an agreement under this subsection; or

"(C) a contract under section 428E.";

(G) by amending paragraph (9) to read as follows:

"(9) <u>TERMINATION OF GUARANTY AGENCY AGREEMENTS</u>.—(A) A guaranty agency's agreement under this subsection may be ended in advance of its expiration date in accordance with subparagraph (B), or (C). If its agreement is so ended, the guaranty agency shall immediately—

"(i) cease to be an agent of the Secretary for purposes of the program under this part; and

"(ii) surrender all remaining liquid and non-liquid reserve funds, and assets purchased or developed with reserve funds, still held by the guaranty agency (including reserves held by, or under the control of, any other entity to the Secretary or the Secretary's designated agent.

"(B) A guaranty agency's agreement under this subsection shall be void, and the Secretary shall immediately so notify such guaranty agency, if—

"(i) the guaranty agency fails to comply in a timely manner with the recall of reserve requirements of section 422(h);

"(ii) the guaranty agency fails to increase the amount of funds in its unrestricted account (as measured by comparing the amount of funds in such account at the beginning and end of a year) for each of two years (that may or may not be consecutive) in the five year period of the agreement under this subsection;

"(iii) any other agreement that the guaranty agency has with the Secretary is terminated;

"(iv) the guaranty agency becomes insolvent or declares bankruptcy; or "(v) there is any legal impediment to the guaranty agency substantially performing its responsibilities under the agreement.

"(C) The Secretary shall, after notice and opportunity for a hearing, terminate a guaranty agency that has substantially failed to achieve an acceptable level of performance under its agreement with the Secretary. A substantial performance failure under this subparagraph may include material internal control weaknesses relating to data quality in the guaranty agency's audits for each of two years (that may or may not be consecutive) in the five year period of the agreement under this subsection.

"(D) Notwithstanding any other provision of Federal or State law, if the Secretary has terminated or is seeking to terminate a guaranty agency's agreement in advance of its expiration date—

"(i) no State court may issue any order affecting the Secretary's actions with respect to such guaranty agency;

"(ii) any contract with respect to the administration of reserve funds held by a guaranty agency, or the administration of any assets purchased or developed with the reserve funds of the guaranty agency, that is entered into or extended by the guaranty agency, or any other party on behalf of or with the concurrence of the guaranty agency, after the date of enactment of the Balanced Budget Act of 1997 shall provide that the contract is terminable by the Secretary upon 30 days notice to the contracting parties if the Secretary determines that such contract includes an impermissible transfer of the reserve funds or assets, or is otherwise inconsistent with the terms or purposes of this section; and

"(iii) no provision of State law shall apply to the actions of the Secretary in terminating the operations of a guaranty agency."; and

(H) by adding after paragraph (9) the following new paragraph:

"(10) USE OF SURPLUS FUNDS.—(A) A guaranty agency with an agreement under this subsection may retain the amount determined in accordance with subparagraph (B) for activities in support of postsecondary education that are approved by the Secretary.

"(B)(i) A guaranty agency may retain 50 percent of its net revenues for fiscal year 1998 in excess of the guaranty agency's need for working capital for such year, as determined after compliance with section 422(h), for approved activities.

"(ii) A guaranty agency may retain for approved activities for fiscal year 1999 and succeeding fiscal years the lesser of—

"(I) 50 percent of its net revenues for such year in excess of its need for working capital, as determined after compliance with section 422(h); or

"(II) the amount of its net revenues for such year in excess of its need for working capital, as determined after compliance with section 422(h), that is equal to a uniform percentage, established annually by the Secretary, of federal revenues received by the guaranty agency for the preceding year. In determining such percentage, the Secretary shall take into account all guaranty agencies' revenues and costs for the preceding year to determine an adequate level of economic incentive for guaranty agencies to maximize their efficiency.

(4) by amending subsection (g) to read as follows:

"(g) DEFAULT PREVENTION FEE PAID BY LENDERS.—(1) An eligible lender shall pay a guaranty agency, to which such lender referred a delinquent loan, a default prevention fee of not to exceed $100 per borrower account if the guaranty agency succeeds in bringing such loan into current repayment status.

"(2) The Secretary shall prescribe in regulations the circumstances in which a lender may obtain a refund of a default prevention fee if the borrower of a loan on which such fee was paid subsequently defaults on such loan."; and

(5) in subsection (l)—

(A) in paragraph (1), by striking the paragraph designation and the paragraph heading; and

(B) by striking paragraph (2).

(b) Section 435(j) of the Act is amended by striking "section 428(b)." and inserting "section 428(c)."

REPEAL OF STATE SHARE OF DEFAULT COSTS

SEC. 6108. Section 428 of the Act is amended by striking subsection (n).

CONSOLIDATION LOANS

SEC. 6109. (a) Section 428C of the Act is amended—

(1) in subsection (a)(3)—

(A) in subparagraph (A), by inserting "in an in-school period," after "for a consolidation loan is"; and

(B) in subparagraph (B), by amending clause (i) to read as follows:

"(i) Eligible student loans received by the eligible borrower may be added to a consolidation loan during the 180-day period following the making of such consolidation loan.";

(2) in subsection (b)(4)(C), by amending clause (ii) to read as follows:

"(ii) provides that interest shall accrue and be paid—

"(I) by the Secretary, in the case of a consolidation loan made before October 1, 1997 that consolidated only Federal Stafford Loans for which the student borrower received an interest subsidy under section 428;

"(II) by the Secretary, in the case of a consolidation loan made on or after October 1, 1997, except that the Secretary shall pay such interest only on that portion of the loan that repays Federal Stafford Loans for which the student borrower received an interest subsidy under section 428; and

"(III) by the borrower, or capitalized, in the case of a consolidation loan, or portion thereof, other than one described in subclause (I) or (II);"; and

(3) in subsection (c)—

(A) in paragraph (1)—

(i) in subparagraph (A), by striking "subparagraph (B) or (C)." and inserting "subparagraph (B), (C), (D), or (E), and subject to subparagraph (F).";

(ii) in subparagraph (C), by striking "after July 1, 1994," and inserting "after July 1, 1994 and before October 1, 1997,"; and

(iii) by adding after subparagraph (C) the following new subparagraphs:

"(D) A consolidation loan made on or after October 1, 1997, that repays loans made under section 428 or 428H, or a combination thereof, shall bear interest at an annual rate on the unpaid principal balance of the loan that is equal to—

"(i) the rate specified in section 427A(g), in the case of a borrower in an in-school or grace period; or

"(ii) the rate specified in section 427A(h)(1) in all other cases.

"(E) A consolidation loan made on or after October 1, 1997, that repays loans made under section 428B shall bear interest at an annual rate on the unpaid principal balance of the loan that is equal to the rate specified in section 427A(h)(2).

"(F) Notwithstanding any other provision of this section, the Secretary may prescribe in regulation such procedures as may be necessary to ensure that—

"(i) a borrower of a consolidation loan that repays a combination of loans eligible to be consolidated under this section, shall continue to receive, after consolidation, any interest subsidy benefits associated with a loan, without extending such benefits to any other loans consolidated that do not have interest subsidy benefits;

"(ii) in the case of a consolidation loan that repays a combination of loans described in subparagraphs (D) and (E), the interest rate on such consolidation loan shall be calculated in a manner that reflects the interest rate applicable to loans made under each such subparagraph; and

"(iii) in the case of a consolidation loan that repays a loan eligible to be consolidated under this section other than those described in subparagraphs (D) and (E), the interest rate applicable to such other loan shall be the interest rate described in subparagraph (D) if such other loan is considered by the Secretary to be subsidized, and the interest rate described in subparagraph (E) if such other loan is considered by the Secretary to be unsubsidized."; and

(B) in paragraph (4)—

(i) by striking "Repayment" and inserting "(A) Except as provided in subparagraph (B), repayment"; and

(ii) by adding after subparagraph (A) (as redesignated by clause (i)) the following new subparagraph:

"(B) In the case of a consolidation loan that repays a loan made under this part for which the borrower is in an in-school period at the time the consolidation application is received, the repayment period for such consolidation loan shall commence after the completion of a grace period, as described in section 428(b)(7)(i).".

CONTRACTS WITH OTHER ENTITIES

SEC. 6110. Part B of title IV of the Act is amended by inserting after section 428D the following new section:

"CONTRACT AUTHORITY

"SEC. 428E. The Secretary may enter into one or more contracts to carry out any of the functions that otherwise would be carried out by a guaranty agency with an agreement under section 428(c).".

ELIGIBLE LENDER

SEC. 6111. (a) Section 435(d) of the Act is amended—

(1) in paragraph (1), by striking "(6)," and inserting "(7),"; and

(2) by adding after paragraph (6) the following new paragraph:

"(7) UNIFORM TERMS AND CONDITIONS.—Subject to such exceptions as the Secretary may prescribe in regulations, the term 'eligible lender' shall not include any lender that offers different terms and conditions to different borrowers of the same type of loan made or insured under this part.".

SPECIAL ALLOWANCE

SEC. 6112. Section 438 of the Act is amended—

(1) in subsection (a)(3), by striking "quarterly rate" each place it appears and inserting "rate";

(2) in subsection (b)—

(A) in paragraph (2)—

(i) by striking "subparagraphs (B), (C), (D), (E), and (F)" and inserting "subparagraphs (B), (C), (D), (E), (F), and (G)"; and

(ii) by adding after subparagraph (F) the following new subparagraph:

"(G)(i) Notwithstanding any other provision of this section, in the case of loans made or insured under this part for which the first disbursement is made on or after October 1, 1997, the special allowance paid pursuant to this subsection shall be computed for any 12-month period beginning on July 1 and ending on June 30 by—

"(I) determining the bond equivalent rate on the preceding June 1 of the securities with a comparable maturity, as established by the Secretary; and

"(II) subtracting the applicable interest rate on such loans from such amount.

"(ii) The amount of special allowance computed under clause (i) shall be paid in quarterly increments for the 3-month periods described in paragraph (1)."; and

(B) in paragraph (3), in the second sentence, by striking "determined for any such 3-month period shall be paid promptly after the close of such period," and inserting "calculated under this subsection shall be paid promptly after the close of the 3-month period for which such special allowance payment is due,".

STUDENT LOAN MARKETING ASSOCIATION OFFSET FEE

SEC. 6113. (a) Section 439(h)(7) of the Act is amended by adding after subparagraph (C) the following new subparagraph:

"(D) The calculation of the fee required under subparagraph (A) or (B), as the case may be, shall be determined on the basis of the principal amount of all loan (except for loans made under sections 428C, 439(o) or 439(q))—

"(i) owned, in whole or in part, by the Association, any subsidiary of the Association, or any company, trust, or other entity owned or controlled by the Association; or

"(ii) held by a trust (including by a trustee on behalf of a trust), or by any other entity in which the Association, or any subsidiary, holds more than a minimal beneficial interest (as determined by the Secretary).".

DIRECT LOAN ORIGINATION FEE

SEC. 6114. Section 452 of the Act is amended—

(1) by striking subsection (b); and

(2) by redesignating subsections (c) and (d) as subsections (b) and (c), respectively.

FUNDS FOR ADMINISTRATIVE EXPENSES

SEC. 6115. Section 458(a) of the Act is amended—

(1) in the first sentence, by striking "$260,000,000" through the end of the sentence and inserting the following: "$532,000,000 in fiscal year 1998, $610,000,000 in fiscal year 1999, $705,000,000 in fiscal year 2000, $806,000,000 in fiscal year 2001, and $904,000,000 in fiscal year 2002.".

HOPE SCHOLARSHIP DEFINITIONS

SEC. 6116. Section 481 of the Act is amended by adding after subsection (f) the following new subsection:

"(g) HOPE SCHOLARSHIP DEFINITIONS.—(1) As necessary for purposes of the tax credit provided under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A), and the deduction provided under section 221 of such Code (26 U.S.C. 221), the Secretary of Education shall define in regulation the following terms:

"(A) academic period;

"(B) normal full-time workload;

"(C) first two years of postsecondary education;

"(D) qualifying grade point average;

"(E) job skills; and

"(F) new job skills.

"(2) Notwithstanding any other provision of law, the regulations described in paragraph (1) shall not be subject to section 482(c).".

HOPE SCHOLARSHIP NEED ANALYSIS AMENDMENTS

SEC. 6117. (a) CALCULATION OF AVAILABLE INCOME.—(1) Section 475 of the Act (20 U.S.C. 1087oo) is amended—

(A) by amending subsection (c)(1)(A) to read as follows:

"(A) the sum of—

"(i) Federal income taxes;

"(ii) the amount of any tax credit taken under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A); and

"(iii) the amount by which tax liability determined without regard to the deduction provided under section 221 of the Internal Revenue Code of 1986 (26 U.S.C. 221) exceeds the amount of tax liability determined after taking that deduction into account;"; and

(B) by amending subsection (g)(2)(A) to read as follows:

"(A) the sum of—

"(i) Federal income taxes;

"(ii) the amount of any tax credit taken by the student under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A); and

"(iii) the amount by which tax liability determined without regard to the deduction provided under section 221 of the Internal Revenue Code of 1986 (26 U.S.C. 221) exceeds the amount of tax liability determined after taking that deduction into account;".

(2) Section 476(b)(1)(A)(i) of the Act (20 U.S.C. 1087pp (b)(1)(a)(i))is amended to read as follows:

"(A) the sum of—

"(i) Federal income taxes;

"(ii) the amount of any tax credit taken under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A); and

"(iii) the amount by which tax liability determined without regard to the deduction provided under section 221 of the Internal Revenue Code of 1986 (26 U.S.C. 221) exceeds the amount of tax liability determined after taking that deduction into account;".

(3) Section 477(b)(1)(A) of the Act (20 U.S.C. 1087qq(b)(1)(A)) is amended to read as follows:

"(A) the sum of—

"(i) Federal income taxes;

"(ii) the amount of any tax credit taken under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A); and "(iii) the amount by which tax liability determined without regard to the deduction provided under section 221 of the Internal Revenue Code of 1986 (26 U.S.C. 221) exceeds the amount of tax liability determined after taking that deduction into account;".

(b) DEFINITIONS.—Section 480 of the Act (20 U.S.C. 1087vv) is amended—

(1) in subsection (a)(2)—

(A) by striking "and no portion" and inserting "no portion"; and

(B) by inserting after "(42 U.S.C. 12571 *et seq.*)," the following: "and no portion of any tax credit taken under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A),";

(2) in subsection (b)—

(A) in paragraph (13), by striking "and" after the semicolon;

(B) by redesignating paragraph (14) as paragraph (15); and

(C) by inserting after paragraph (13) the following new paragraph:

"(14) any tax deduction taken under section 221 of the Internal Revenue Code of 1986 (26 U.S.C. 221); and";

(3) in subsection (e)—

(A) in paragraph (3), by striking "and";

(B) in paragraph (4), by striking the period and inserting "; and"; and

(C) by adding after paragraph (4) the following new paragraph:

"(5) any tax credit taken under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A); and";

(4) in subsection (j), by adding after paragraph (3) the following new paragraph:

"(4) Notwithstanding paragraph (1), a tax credit taken under section 24A of the Internal Revenue Code of 1986 (26 U.S.C. 24A) shall not be treated as estimated financial assistance for purposes of section 471(3).".

INCOME PROTECTION ALLOWANCE

FOR INDEPENDENT STUDENTS WITHOUT DEPENDENTS

SEC. 6118. (a) Section 476(b) of the Act is amended—

(1) in paragraph (1)—

(A) in subparagraph (A)—

(I) by amending clause (iv) to read as follows:

"(iv) an income protection allowance, determined in accordance with paragraph (4);"; and

(II) in clause (v), by striking "paragraph (4);" and inserting "paragraph (5);"; and

(B) in subparagraph (B), by striking "paragraph (5)." and inserting "paragraph (6).";

(2) by redesignating paragraphs (4) and (5) as paragraphs (5) and (6), respectively; and

(3) by inserting after paragraph (3) the following new paragraph:

"(4) INCOME PROTECTION ALLOWANCE.—The income protection allowance is determined by the following table (or a successor table prescribed by the Secretary under section 478):

"INCOME PROTECTION ALLOWANCE

FAMILY SIZE	NUMBER IN COLLEGE	
(including student)	1	2
1	8,000	
2	10,520	8,720

".

(b) Section 478(b) of the Act is amended by striking "sections 475(c)(4) and 477(b)(4)." and inserting "sections 475(c)(4), 476(b)(4), and 477(b)(4).".

EXTENSION OF STUDENT AID PROGRAMS

SEC. 6119. Title IV of the Act is amended—

(1) in section 401(a)(1), by striking "September 30, 1998," and inserting "September 30, 2002,";

(2) in section 413A(b)(1), by striking "$675,000,000

for fiscal year 1993" and inserting "$583,407,000 for fiscal year 1998";

(3) in section 424(a), by striking "1998." and "2002." and inserting "2002." and "2006.", respectively;

(4) in section 428(a)(5), by striking "1998," and "2002." and inserting "2002," and "2006.", respectively;

(5) in section 428C(e), by striking "1998." and inserting "2002.";

(6) in section 441(b), by striking "$800,000,000 for fiscal year 1993" and inserting "$857,000,000 for fiscal year 1998";

(7) in section 461(b)—

(A) in paragraph (1), by striking "$250,000,000 for fiscal year 1993" and inserting "$158,000,000 for fiscal year 1998"; and

(B) in paragraph (2), by striking "fiscal year 1997" and "October 1, 1997," and inserting "fiscal year 2002" and "October 1, 2002,", respectively; and

(8) in section 466—

(A) in subsection (a)—

(i) in the matter preceding paragraph (1), by striking "September 30, 1996," and March 31, 1997," and inserting "September 30, 2001," and March 31, 2002,", respectively; and

(ii) in paragraph (1), by striking

"September 30, 1996," and inserting "September 30, 2001,";

(B) in subsection (b), by striking "March 31, 2005," and "September 30, 1996," and inserting "March 31, 2010," and "September 30, 2001," respectively; and

(C) in subsection (c), by striking out "October 1, 1997," and inserting "October 1, 2002,".

EFFECTIVE DATES

SEC. 6120. (a) Except as otherwise provided in this section, the amendments made by this subtitle shall take effect on the date of enactment of this Act.

(b) Section 6103 is effective for a loan made under part B or part D of title IV of the Act for which the first disbursement is made on or after October 1, 1997.

(c) Section 6104(a)(3) and section 428(b)(5)(C) of the Act (as added by section 6107(a)(2)(E)) are effective as if they were enacted on July 23, 1992.

(d) Sections 6105, 6110, and 6111 take effect on October 1, 1997.

(e) Section 6112 is effective for a loan made, insured, or guaranteed under part B of title IV of the Act for which the first disbursement is made on or after October 1, 1997.

(f) Section 6113 is effective as if it were enacted on August 10, 1993, but does not apply to the privatized entity that may be created as a result of the Student Loan Marketing

Association Reorganization Act of 1996 (Title VI of the Departments of Labor, Health and Human Services, Education, and Related Agencies Appropriations Act, 1997, as enacted by section 101(e) of Division A of Pub.L.No. 104-208).

(g) Section 6117 is effective for determinations of need for academic years beginning on or after July 1, 1998.